Report No. 30714

Croatia
Country Assistance Evaluation

November 17, 2004

Operations Evaluation Department

Document of the World Bank

Currency Equivalents (annual averages)

US$1-HRK6.563

(as of July 1, 2003)

Fiscal Year

January 1-December 31

Abbreviations and Acronyms

ASAL	Agricultural Sector Adjustment Loan
CARDs (EU)	Community Assistance for Reconstruction, Development, and Stabilization of the European Union
CAS PR	Country Assistance Progress Report
CAS	Country Assistance Strategy
CEE	Central and Eastern Europe
CEECs	Central and Eastern European Countries
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CMEA	Council for Mutual Economic Assistance
CNB	Croatian National Bank
CPAR	Country Procurement Assessment Report
CPF	Croatian Privatization Fund
DFID	Department for International Development
EAs	European Agreements
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EFF	Extended Fund Facility
EFSAL	Enterprise and Financial Sector Adjustment Loan
ERP	Emergency Reconstruction Project
ESW	Economic and Sector work
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FRY	Former Republic of Yugoslavia
FSSA	Financial System Stability Assessment
GDP	Gross Domestic Product
GTZ	Gesellschaft für Technische Zusammenarbeit
HDZ	Croatian Democratic Party
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
IDF	International Development Fund
IDI	Institutional Development Impact
IFC	International Financial Corporation
IFIs	International Financial Institutions
IMF	International Monetary Fund
ILO	International Labor Organization
MEI	Ministry of European Integration
MIGA	Multilateral Investment Guarantee Agency
NATO	North Atlantic Treaty Organization
NGO	Non-governmental Organizations
OECD	Organization for Economic Co-operation and Development
OED	Operations Evaluation Department
PAL	Program Adjustment Loan
PEIR	Public Expenditure Institutional Review
PSD	Private Sector Development
QAG	Quality Assurance Group
R&D	Research and Development
SAA	Stabilization Association Agreement
SAL	Structural Adjustment Loan
SBA	Standby Arrangement (IMF)
SFRY	Socialist Federal Republic of Yugoslavia
SIGMA	Support for Improvement in Governance and Management
SME	Small and Medium Enterprise
SOEs	State Owned Enterprises
TA	Technical Assistance
UN	United Nations
UNDP	United Nations Development Program
USAID	United States Agency for International Development
USSR	Union of Soviet Socialist Republics
WTO	World Trade Organization

Director-General, Operations Evaluation	:	Mr. Gregory K. Ingram
Director, Operations Evaluation Department	:	Mr. Ajay Chhibber
Senior Manager, Country Evaluation & Regional Relations	:	Mr. R. Kyle Peters
Task Manager	:	Mr. René Vandendries

Contents

Contents *(cont.)*

Preface

This evaluation provides an independent assessment of the role of World Bank assistance to Croatia during 1991-2003. The Country Assistance Evaluaton (CAE) examines whether: (a) the objectives of Bank assistance were relevant; (b) the Bank's assistance program was effectively designed and consistent with its objectives; and (c) the Bank's program achieved its objectives and had a substantial impact on the country's development during this period. Examining these questions allows the CAE to draw lessons and recommendations for future Bank assistance. Annex D describes the methodological approach.

The basis for the CAE consists of OED project assessments, sectoral reviews, and interviews with past and present government officials, Croatian civil society, other donors, as well as Bank and IMF staff at headquarters and in Croatia. A list of those interviewed is shown in Annex B. An OED mission visited Croatia in May 2003.

Comments received from the Regional staff are reflected in the report. The report was also sent to the Croatian authorities, whose comments are in Annex E.

The Country Assistance Evaluation was written by Michael Lav (Consultant). John Johnson, Csaba Feher (Consultant) provided support concerning pension reform, and Roy Jacobstein (Consultant) provided support in the health sector. This evaluation also benefited from comments of two peer reviewers: Ms. Poonam Gupta (OED) and Mr. Pedro Alba (MNA). Danuta Danilova provided research assistance. Tirsit Dinka and Janice Joshi provided administrative support.

Summary

1. Croatia gained independence in June 1991, but civil war and hostilities with neighboring countries together with the economic impact of the break-up of the former Socialist Federal Republic of Yugoslavia caused per capita income to fall in 1993 to two-thirds of its 1990 level. Starting in 1994 both the economic and political situation began to stabilize and a recovery began. The recovery was interrupted in 1999 when the fiscal deficit got out of control, but subsequently resumed. By 2002 per capita income had regained its 1990 level. Underlying the recovery were the rebound and growth of tourism, a high level of worker remittances, private credit expansion, and public deficit spending.

2. Economic policymaking and the reform process have been uneven. On the positive side, macroeconomic stabilization was achieved quickly, which facilitated the recovery. Trade was liberalized, financial sector reforms were very successful, and the environment for private sector development improved, albeit slowly. Some of these reforms accelerated in 2000, when a new government improved ties with Western Europe and firmly launched Croatia's bid to join the European Union (EU). Since then the country also has joined the World Trade Organization (WTO). But, inefficient public spending in several areas—transport, health, social spending—has contributed to excessive public sector deficits with limited positive outcomes. Growth has been constrained by a corrupted privatization process, and many enterprises now failing were privatized with contracts allowing sale of assets back to the state. The net result of all this has been a rapid increase in the current account deficit and external debt, without commensurate improvements in growth and poverty reduction. A politicized and inexperienced public administration and an ineffective judicial system are also much in need of reform.

3. Since 1993, the Bank has lent a total of US$1,198 million to Croatia, for 23 operations, with initial emphasis on reconstruction, followed by public finance reform, growth, and public administration and judicial reform. Although the government refused permission throughout the 1990s to carry out some important economic and sector work (ESW) tasks such as public expenditure reviews and a poverty assessment, these have since been implemented, together with Country Economic Memoranda that detail clear reform priorities.

4. The reconstruction loans had successful outcomes. Operations to reform public finance have had mixed success. Although some reforms (such as pensions and health) started in the 1990's, these were not wide-ranging, and public expenditures continued to grow with little retargeting. Since 2000, reforms have been deepened in pensions and health, and initiated in other areas, supported by Bank ESW and lending. Public expenditures, while still high, have since decreased as a percentage of GDP.

5. Operations to help raise growth have also had mixed impact. The FY97 EFSAL privatization program was flawed, while financial sector reform was successful. The FY02 SAL reforms should have a positive impact on the labor market, and the new bankruptcy and company laws should help improve enterprise performance over time.

6. The impact of operations to strengthen public administration also has been limited.

The SAL that has just closed helped improve some aspects of budget management. The FIAS study on administrative barriers provided a useful guide to action, but has only been partially implemented. Judicial reform is moving slowly, and the Court and Bankruptcy Reform LIL has had only halting success, as has the more recent Cadastral Project.

7. Experience in Croatia emphasizes the importance of Bank-Borrower agreement on reform. Although Bank actions are largely responsible for Bank performance, they are only one contributor to the outcome and institutional development impact of the Bank's assistance strategy. Outcomes are also determined by the Borrower's performance and other factors. OED has rated as satisfactory the outcome of only 65 percent of loan commitments, below the average for the Europe and Central Asia (ECA) Region and the Bank as a whole. On the basis of these ratings, the low impact of ESW and slow progress by the government on economic reforms, the overall outcome of the Bank assistance program is rated as unsatisfactory through FY01. Subsequently, with accelerated reforms supported by Bank assistance including the SAL and more effective ESW, the overall outcome of the Bank assistance program merits a rating of satisfactory.

8. Sustainability is rated as likely given Croatia's determination to join the EU and its conclusion of the EU Stabilization and Association Agreement, as well as OED's evaluation of likely sustainability in all its loan commitments. But to mitigate risks, the government will have to pursue its reform agenda vigorously. Institutional Development Impact (IDI) is rated as modest for the first time period but substantial for the second. IDI is rated as substantial in only 28 percent of loan commitments, well below ECA and Bank averages, but ESW has had an important impact in the later period.

9. The contrast in outcome ratings suggests that ambitious adjustment and assistance programs should not be pursued when governments are unconvinced of the need for reform. With the Bank now playing an increasingly relevant role, and as agreement is reached on priorities with the new government, elected in November 2003, the Bank should aim at assisting Croatia to:

(i) Rationalize and retarget public expenditure to support reforms in health, education, and infrastructure and to contain debt;

(ii) Foster private sector–led growth: first, by improving the environment for founding new enterprises and, second, by ensuring that privatization of SOEs (or reprivatization of failed enterprises that are reverting to government ownership) is successful, in particular, by not favoring insider buyouts; and

(iii) Improve the core functions of government, public administration, and the judicial sector.

Gregory K. Ingram
Director-General
Operations Evaluation

1. Country Background

Description

1.1 Croatia is a middle income country bordered by Bosnia-Herzegovina, Hungary, Serbia and Montenegro, and Slovenia. In 2002, the population of 4.4 million had a per capita income of US$4,640 (Atlas Methodology).

Initial Conditions

1.2 Croatia declared independence from the former Socialist Federal Republic of Yugoslavia (SFRY) in June 1991. It faced the loss of markets within former SFRY and the Council for Mutual Economic Assistance (CMEA), extensive destruction of capital stock during the ensuing war, sharp declines in output, and severe inherited inflation coming on top of investment levels that had been falling since the early 1980s. Transport from the North and East to the South was disrupted as some rail lines and roads ran through Bosnia-Herzegovina. Advantages included a population with substantial technical skills, an inherited economic system which was far more market-oriented than those of the planned economies of Central Europe and the former USSR, a relatively liberal foreign trade regime with few quantitative restrictions (mainly in agriculture), low tariffs, and no trading monopolies. The population of 4.8 million at independence had a per capita income of US$3,350.

1.3 After independence, hostilities erupted almost immediately, and turbulence continued until 1998. More than one-fourth of Croatia's territory had large Serb populations and was designated as U.N. Protected Areas (UNPAs) in January 1992, but hostilities with Serbia ensued during which Croatia lost the southern Kordun and Banija[1] region and Eastern Slavonia. Croatia regained the Kordun and Banija region in 1995, while Eastern Slavonia was fully re-integrated into Croatia in 1998. On another front, hostilities also erupted within Bosnia-Herzegovina, among Serb, Croat, and Muslim populations during which Croatia lent support to the Croats. The Dayton Accords signed in 1995 ended hostilities, but international concerns about relations with Bosnia-Herzegovina, including border crossings, trade, and Croatia's funding of Bosnian Croats, were not addressed until 1997.

1.4 Franjo Tudjman was elected President by Parliament in 1990 and re-elected to five year terms in direct Presidential elections of 1992 and 1997, as leader of the Croatian Democratic Party (HDZ) which dominated politics. The war years were a very difficult period for Croatia. For a time, the country lost part of its territory, it suffered heavy casualties, had to deal with refugees and substantial economic damage. However, following the end of hostilities in 1995, decision making was increasingly centralized in the Presidency, and there was a lack of transparency in many government actions including privatization and public expenditures detailed elsewhere in this report. The

[1] The Kordun and Banija region has had a large Serbian population since Croatia was ruled by the Austro-Hungarian Empire which encouraged Serbs to settle the region as a bulwark against the Ottoman Empire.

1998-99 economic recession led to some loss of support for the government. Nonetheless, President Tudjman remained in power until his death in December 1999.

1.5 Since then, democratic processes have become more transparent. Croatia was governed from 2000 through 2003 by a multiparty coalition whose members were bound together by an outward orientation with the goal of leading Croatia towards full EU membership. Croatia has signed an EU Stabilization and Association Agreement (SAA)[2] and the NATO Membership Action Plan, and has become a member of WTO, while signing free trade agreements with 30 countries. In the elections of November 2003 the HDZ received a plurality and has formed a new government. Its stated intention is to pursue policies which would enable Croatia to join the EU as quickly as possible. To achieve this objective, the new government will need to carefully formulate a fiscally responsible program while pursuing a large number of reforms. This will not be easy and will require political will, but the alternative would be all too costly for Croatia's future.

Economic and Social Challenges 1990-2002

Macro Perspectives

1.6 The initial challenge was stabilization to restore the basis for growth. From 1991 to 1993 inflation exceeded 200 percent per year, real GDP dropped by 28 percent and real wages by 64 percent. The October 1993 stabilization program was launched after informal consultations with the IMF and the World Bank. It sharply reduced inflation and restored growth. Debt agreements were reached with creditors at the Paris Club in 1995 and at the London Club in 1996. During 1994–2002, GDP increased by

Table 1.1: Croatia, Key Economic Indicators, 1994-2002

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Real sector				(percentage change)					
Real GDP	5.9	6.8	5.9	6.8	2.5	-0.9	2.9	3.8	5.2
Exports of goods and services	...	...	9.8	7.6	3.9	0.7	12.0	9.5	3.0
Imports of goods and services	...	...	6.8	25.1	-4.9	-3.5	3.7	11.1	11.0
Fixed investment	...	...	37.6	23.3	2.5	-3.9	-3.8	9.7	10.1
Private consumption	...	...	0.4	12.9	-0.6	-2.9	4.2	4.6	6.6
Average CPI Inflation	97.5	2.0	3.5	3.6	5.7	4.2	6.2	4.9	2.2
Gross real wages	...	34.0	12.3	21.0	12.6	10.2	7.0	3.9	6.0
Unemployment rate [1]	...	...	10.0	9.9	11.4	13.6	16.1	15.8	14.4
				(in percent of GDP)					
Exports of goods and services	45.8	38.6	40.2	41.1	39.6	40.9	47.1	49.1	46.0
Imports of goods and services	45.9	49.5	49.7	56.8	49.2	49.3	52.3	54.7	54.8
General Government									
Overall balance	1.5	-1.4	-2.2	-3.1	-2.0	-8.2	-6.0	-6.8	-4.8
Expenditures	44.1	48.9	51.9	51.3	53.8	57.0	53.2	51.5	50.0
Public debt [2]	22.3	19.5	31.7	35.6	42.3	54.1	59.7	58.0	68.5
External Accounts									
Current account balance	4.9	-7.5	-4.8	-12.5	-6.7	-7.0	-2.5	-3.7	-7.2
FDI (Net)	0.7	0.5	2.6	1.5	3.9	7.2	5.7	7.2	4.0
External Debt	20.7	20.2	26.7	37.1	44.8	50.1	60.0	57.9	68.1
Reserves (months of imports)	2.4	2.5	2.8	2.7	3.2	3.7	4.4	4.4	4.4

[1] ILO; [2] Includes central government domestic and external debt plus public guarantees (both financial and performance guarantees).
Sources: CEM FY04 and IMF.

[2] The Stabilization and Association Agreement (SAA) covers trade liberalization, political dialogue, mutual right of establishment of firms, supply of services, liberalization of capital flows, movement of workers and various forms of cooperation. SAAs differ from the Europe Agreements (EAs) in the political pre-conditions, legislation harmonization, and trade cooperation that have to be met prior to starting negotiations on the agreement, and SAA countries are only potential candidates for EU membership. In addition to Croatia, other SAA countries are Bosnia and Herzegovina, Federal Republic of Yugoslavia, former Yugoslav Republic of Macedonia, and Albania. See Croatia CEM (FY04).

4.3 percent per year, inflation averaged only 4 percent per year, and exports of goods and services grew by 6 percent per year (see Table 1.1). Croatia is now one of the most open economies in Central Europe, and Croatia's credit rating was established at investment grade in early 1997.

1.7 At the same time, the country faced major structural problems and made uneven progress towards their resolution over the period under review. They include inefficiencies in public spending, lack of sustainable progress in privatization, resulting in GDP growth rates below potential, and rapidly increasing external debt, as well as governance issues. The challenges faced by Croatia are presented immediately below. Chapter II presents the Bank's assistance to help Croatia address these challenges while the development impact of the Bank's assistance program is discussed in Chapter III.

Public Sector Expenditure and Debt

1.8 GDP growth, primarily based on a rebound of tourism and large volumes of workers remittances , has been further stimulated by large public sector deficits which re-emerged in 1995 and increased through 1999, caused by large and ill-targeted public expenditure programs. The government elected in 2000 applied some fiscal restraint, and public expenditure declined from 57 percent of GDP in 1999 to 50 percent in 2002 (still one of the highest in the region), while the overall deficit declined from 8.2 percent of GDP in 1999 to 4.8 percent in 2002. These budget deficits including bailouts and financing of health and other funds, resulted in a large build-up of debt. Public and publicly guaranteed external debt reached the equivalent of 52 percent of GDP by end-2003. Further reductions of deficits are called for as well as pro-growth reforms discussed below, without which indebtedness will continue to be a problem, and a barrier to EU accession. Also there was a large increase in total external debt between 2002 and 2003, from the equivalent of 68 percent to above 80 percent of GDP, but this increase was primarily on account of the private sector.

1.9 *Public expenditure* policy has faced numerous challenges. In highways, it was to maintain the existing road network to good standards and limit new highway construction to economically justifiable roads, given the legitimate need for Croatia to secure some new transport routes within its territory. In railroads, it was to improve management and the enterprise's financial position by trimming expenditures and non-essential activities and employment with a view to possible privatization. The challenge in education, where 30 percent of the population has only 8 years or less of schooling, and 1 percent are illiterate, was to reform an outdated curriculum and improve generally ineffective teaching methods.[3] The challenge in health was to realign capacity from an excessive focus on secondary and tertiary health care to a stronger focus on primary health care, from which physicians could then direct patients to secondary facilities more efficiently. In pensions, the challenge was to modernize and reform an unsustainable pension system while ensuring adequate protection for the elderly. Many of these challenges remain: among the most urgent ones are improving the efficiency of spending in highways and health, and reducing railway subsidies.

[3] Data updated in accordance with the government's comments (annex E).

Sustainable Growth

1.10 Moving to a sustainable growth path requires a number of reforms in the *productive sectors*. In industry, the challenge was to pursue privatization of the State-owned enterprises (SOEs) and to create an environment in which both new private sector enterprises and privatized SOEs could grow. The challenge in *financial sector* reform was to privatize the state-owned banks and allow for the growth of private sector banks which were adequately capitalized, all within an effective regulatory system. In the *agriculture* sector, comprising privately-owned farms and Agrokombinats, the challenge was to improve land policies and build on trade reforms to allow the competitive private sector to grow, while limiting bailouts and subsidies to the less competitive Agrokombinats. Apart from successful financial sector reform, here also much remains to be done. In particular, the privatization process lacked transparency and has been characterized by insider buyouts, stripping of assets and illicit use of company assets to collateralize and guarantee private mortgages. Since privatization arrangements frequently included buy-back clauses allowing workers who purchased shares to sell them back to the state, many failing privatized enterprises have reverted to public ownership. Many of the large-scale state-owned enterprises which ought to have been privatized by now have not been. Finally, good corporate governance, crucial for sustainability, has been lacking although this has recently improved.

1.11 A more efficient economy would also benefit Croatia's balance of payments. Merchandise export growth has been lagging, and 20 percent of foreign exchange receipts is accounted for by FDI[4] and workers remittances, and about 30 percent by tourism. While these inflows enabled foreign exchange reserves to increase to the equivalent of 4.4 months of imports at end 2002,[5] the current account deficits, on the order of 7 percent of GDP in 2002/03, remain too large.

The Governance Challenge

1.12 Public administration and the judiciary required reforms for Croatia to become a well-governed democracy with a responsive market economy. Public administration has lacked the capacity to generate and implement policies and programs consistent with a market economy. The court system is an important impediment to progress. There is a backlog of over 1 million cases,[6] so that resolution of bankruptcy and other proceedings are seriously delayed thereby impeding resolution of disputes. Capacity is not the core issue, as, for example, the City Court of Zagreb is one of the largest in Europe with 350 judges. Procedures are cumbersome. There is little incentive for judges to settle cases expeditiously. There are no administrative courts, so even minor disputes are referred to

---

[4] Most FDI has been in a few large privatized enterprises (especially telecommunications and pharmaceuticals) and three large privatized banks.

[5] There is, however, an added element of uncertainty in that the magnitude of workers' remittances and tourism in Croatia's very open economy makes data collection difficult, leading to large errors and omissions in the balance of payments, which came to minus $1 billion in 2002.

[6] This is a rough estimate because cases receive new identification numbers as they are appealed and heard in different courts.

the judicial courts. Resources are lacking; for example, there is inadequate access to precedents and there are few trustees available to implement bankruptcy proceedings.

Poverty and Social Issues

1.13 Poverty measured by the standard used across transition countries (US$4.30 a day per person) is at 4 percent, while poverty according to the Millennium Development Goals is at 1 percent.[7] Unemployment is high at 14 percent reflecting past labor market rigidities including constraints which limit layoffs and greatly increase their costs thereby inhibiting new hires. Individual dismissals are costly and there have been many barriers to collective dismissals and substantial legal restraints to temporary employment. Many workers lack adequate skills to participate in emerging markets. Finally, the privatization problems discussed above and administrative barriers to enterprise development limit job creation which is equivalent to only 3.5 percent per year of the labor force, a very low rate compared to EU accession and EU countries.[8]

[7] Lack of adequate accounting for refugees and their role in the economy may lead to some underreporting.
[8] See Croatia Country Economic Memorandum, Report No. 25434-HR, Chapter 6. For example, the rate of job creation in 2000 for Bulgaria was 6.8, for Lithuania (1998-99) 9.7, Poland (1998-99) 5.3, France (1984-91) 6.6, and Germany (1983-90), 6.5.

2. World Bank Products and Services

Strategic and Policy Advice

2.1 A dialogue on Bank assistance began soon after independence, but was interrupted for about a year due to security concerns. Croatia became a member of the Bank on February 25th, 1993 as one of the successor states of the former Socialist Federal Republic of Yugoslavia. The cease fire instituted in March 1994, between Serbian and Croatian forces in Croatia, and the "Washington Agreements" which provided a framework for peaceful resolution of disputes allowed the Bank to resume work on an assistance program, leading to the Board's approval of the Emergency Reconstruction Project in June 1994, followed by a Health Project in February 1995.

Country Assistance Strategies

2.2 The mid-1990's country strategy[9] sought to support Croatia's transition from stabilization to transformation with sustained growth by: (1) reforming public finance; (2) encouraging private sector-led growth, and (3) rebuilding and upgrading infrastructure. A poverty assessment and a CEM were planned for FY96. These were relevant objectives, although there was no focus on governance. However, the government did not consistently accept wide-ranging reforms and at times rejected adjustment lending, while the Bank's Board of Directors remained concerned about Croatia's support for Bosnian Croats, seen as regionally destabilizing. The country strategy proposed a base case lending program for FY95-98 of US$690 million.

2.3 The 1999 CAS was a joint IBRD/IFC document with the objective of: (i) reducing the size of the public sector and increasing efficiency; (ii) improving governance; (iii) creating conditions for competitive real sector development; and (iv) containing poverty. These objectives were in accord with the challenges facing Croatia, but the program proposed in the CAS did not take adequate account of the government's unwillingness to accept a strong reform program in governance, privatization, and other key areas. A base case lending program of US$589.9 million for FY99–02 was proposed, including a SAL for US$200 million and a railway modernization project for US$101 million. The long-delayed public expenditure review and poverty assessment were again proposed.

2.4 The 2001 CAS Progress Report (CAS PR), prepared jointly with IFC, was drafted after the coalition government took office following the death of President Tudjman. The CAS PR again proposed a wide-ranging reform program with a base case scenario for FY02-03 for US$282.0 million including the SAL.

2.5 *Evaluation of Strategies.* The strategies presented in the two CASs were generally well designed with a focus on the three issues (public sector expenditure, sustainable growth, and, starting with the second CAS, governance) identified in Chapter 1, but were

[9] The country strategy was presented to the Board after the Emergency Reconstruction Project and Health Project were approved.

not fully relevant because they assumed that the end of open hostilities presaged government support for a broad structural adjustment program. Intentions to reform public investment and administration, and the judiciary, were difficult to operationalize. The FY99 CAS recognized shortcomings in privatization but did not propose solutions, nor did it address some priorities such as education. The client survey conducted in 1998 revealed that poverty reduction was not perceived as a Bank priority. As mentioned, Bank support for adjustment was also limited for a time by Executive Directors' concerns that Croatia was providing budgetary support for Croats in Bosnia, and was contributing to regional instability. As adjustment lending failed to materialize, the Bank allowed infrastructure lending to expand and supported a larger public investment program with limited retargeting, at a time when Croatia needed to reduce and retarget public expenditures. (The FY99 CAS base case lending program oddly did not program any adjustment lending to follow the SAL because of a presumed weakening commitment to reform.) The strategy in the CAS PR was more relevant, because by this time the government was willing to pursue reforms and actively sought a rapprochement with the European Union.

Implementation of Strategies: Overview

2.6 Bank lending has totaled US$1,198.1 million through FY04 (see Table 2.1 below), of which US$168 million occurred before a country strategy was approved,[10] and US161.5 million thus far in FY04 after the CAS PR. Lending during the CAS periods fell short of CAS proposals by 25 percent (US$868.6 million achieved compared to US$1,141.9-US$1,191.0 million proposed), but this hides a much larger mismatch as 12 proposed projects were dropped while 4 projects not proposed in CASs were approved. As a result of this, and together with slippage in approving proposed lending, only 30 percent of lending was approved as proposed in a CAS, while another 30 percent of lending was approved without having been proposed in a CAS, although this was mostly reconstruction lending well-tailored to the emerging situation. Forty percent of lending had been proposed in a CAS but was approved only after 1 to 4 years delay. Finally, some investment operations increased dramatically in size, which acted as an offset to the dropped adjustment operations. The delays occurred during both the mid-1990's and FY99 country strategies, while implementation has been on target since the CAS PR in FY02, including the SAL. See Attachment 1, which lists all loans proposed and implemented relative to the CASs.

Table 2.1: Proposed and Actual Lending (US$ Millions)

Lending	*Pre-1995 country strategy*	*mid-1990's country strategy*	*1999 CAS*	*2001 CAS Progress Report*	*Total CAS 1995-2001*	*Post-CAS Progress Report, 2004*	*TOTAL 1994-04*
Proposed		*300.0-350.0*	*589.9*	*277.0*	*1166.9-1216.9*		*1141.9-1191.0*
Actual	**168.0**	**457.4**	**156.2**	**255.0**	**868.6**	**161.5**	**1,198.1**

*The 1999 CAS proposed lending of US$160 million in 2002 which was superceded by the CAS PR. Lending for FY04 comprised the Rijeka Port project from the CAS PR and a new energy project.

Sources: Business Warehouse as of 09/02/2003, mid-1990's country strategy, CAS 1999, CAS Progress Report 2001.

[10] In addition, from 1969 to 1989, 20 loans for US$263.9 million were granted to the former SFRY which resulted in tangible asset creation in the territory of Croatia. Since these were not the result of a country assistance strategy for Croatia, they are treated only if and when they had a specific impact on the country assistance strategy. One such loan is Istria Water and Sewerage, approved in 1988 but for which implementation continued until 2002, and which addressed specific environmental concerns.

2.7 In essence, the Bank's actual lending program to date has focused on infrastructure and reconstruction (see table 2.2), while shortfalls in adjustment, governance, judicial reform, public administration, poverty reduction, education, and, to a lesser degree, health, reflected dropped projects and delays. Important issues such as fiscal adjustment came to be addressed only towards the end of the period, leaving for the future a larger work-out program than would have otherwise been needed.

Table 2.2: IBRD Commitments by Sector
(as of December, 2003)

Sector	*Total (US$ million)*	*Percent*
Economic Policy	202	17
Energy	5	1
Financial Sector	134.5	11
Health, Nutrition, Population	69	6
Private Sector Development	12.3	1
Public Sector Governance	5	1
Rural Sector	84.7	7
Social Protection	27.3	2
Transport	453.4	38
Urban (includes Reconstruction)	168.6	14
Water Supply and Sanitation	36.3	3
Total	**1198.1**	**100**

Source: Business Warehouse.

ESW: Overview

2.8 Through the 1990's, important components of the proposed ESW program (especially the public expenditure review and the poverty report) could not be implemented because of a lack of government agreement, while the impact of the work which was completed was low, even if it was generally of good quality. From FY01 and the CAS PR on, both the overall quality and impact of the program have been satisfactory. The program is reviewed in more detail later in Chapter II and its impact evaluated in Chapter III.

Table 2.3: Ratings on Closed Projects, FY99-FY03
(percent, by commitment amount)

	Satisfactory Outcome	*Likely Sustainability*	*Substantial Institutional Development*
Croatia	65	100	28
CEEC (Excl. Baltics)	92	87	65
ECA	79	81	54
Bankwide	81	76	53

Source: Statistical annex A, table 5a and, for CEEC, Business Warehouse database as of October 2003, for FY89-FY03.

Lending: Overview of Project Quality

2.9 Project evaluations by OED to date largely reflect projects formulated, approved and implemented during the more difficult years through FY01. For example, the Highway Sector loan with its unsatisfactory outcome rating supported a three year time slice of the highway program, from 1995-97. The Croatia portfolio has so far performed less well than the average for ECA, with only 65 percent of lending receiving satisfactory ratings,[11] compared to 79 percent for ECA and 81 percent for the Bank as a whole. Croatia fares even less well when compared to its cohort of CEE countries, excluding the Baltic countries. The ratings for Institutional Development Impact also are below average for ECA and the Bank as a whole. All projects are rated high in sustainability.

[11] Ratings are based on Business Warehouse data updated by the ratings in the Project Performance Assessment Report for the Highway Sector, EFSAL, TA, Capital Market Development, Emergency Transportation and Mine Clearing, and Istria Water Supply loans.

2.10 The picture for the 11 ongoing projects is quite different than that for closed projects. Croatia fares better than ECA and Bankwide averages in ratings for ongoing projects, with no projects rated at risk. Intensive project supervision and, for post FY00 projects, more careful project formulation with active participation of a more reform-minded government are all factors which play a role in this improvement. In addition, the World Bank Country Office plays a proactive role in addressing issues before they become problematic.

Table 2.4: Active Projects

	Projects at risk, percent, by number
Croatia	0.0
ECA	8.0
Bankwide	16.4

Source: Statistical Annex 5, table 5c.

Reconstruction Lending

2.11 Reconstruction played an important role in Bank assistance through much of the 1990s. The Emergency Reconstruction loan (FY94) was useful in financing equipment and parts lost in the war, power, flood control, and community reconstruction, and its outcome was rated satisfactory. The Coastal Forest Reconstruction and Protection Project (FY97) is helping to restore and protect forest land in the coastal zone, which was important for the environment and tourism. The Emergency Transportation and Mine Clearing project (FY97) financed reconstruction of roads, bridges, and railway lines, repairs to Ploce Port, and mine clearing. It also improved governance in opening up demining operations to international competitive bidding. Eastern Slavonia (FY98) supported reconstruction of war-damaged infrastructure, improvement of flood control and wastewater management, and clearing of land mines.

Containing and Retargeting Public Expenditure to Reduce the Debt Burden

2.12 Little was achieved in this area during the 1990s, but some progress has been made post-FY01. The Bank has supported reform of the large and poorly targeted public expenditure program. Two pieces of ESW have played an especially important role. "*Croatia: A Policy Agenda for Reform and Growth*" (February 2000) assisted the then new government to formulate its agenda. It observed that government expenditure had increased by more than 15 percentage points of GDP since independence, that deficits were growing, and that the transformation of productive sectors had stalled. It proposed reductions in transfers and expenditures on defense, social security, public sector wages and employment, acceleration of efforts to privatize state-owned banks and measures to create a business friendly environment. Reforms were proposed to improve allocative efficiency, provide incentives for domestic savings and investment, and promote education. It was well received and many of its suggestions are being implemented.

2.13 The Public Expenditure and Institutional Review (PEIR) "*Croatia: Regaining Fiscal Stability and Enhancing Effectiveness*" (FY02),[12] which had been blocked for years by the previous government, detailed the causes of increased public sector spending and fiscal deficits. The PEIR proposed specific reforms in public sector wage management, health, pensions, education, social assistance and child allowances, publicly owned

[12] The study was also published as a World Bank Country Study in March 2002.

transportation, and the need for further reductions in defense outlays, and identified process improvements in budget management. In so doing, it drew on an, internal note on health policy, the FY97 CEM, and "*Croatia: A Policy Agenda for Reform and Growth*" (FY00). Many of the proposals are being implemented. Most recently, the Croatia Country Economic Memorandum (FY04) presented a program for fiscal reforms with a strategy for growth through European Integration, based on the Stabilization Association Agreement. It is too early to gauge impact, but the report was well-received.

2.14 Adjustment lending played a central role in Bank assistance to reform the public expenditure program. The SAL (FY02) supported improved coordination and management in economic policy making, enhancing fiscal discipline through limiting excessive and poorly targeted government expenditures with the help of improved budget processes, transparent subsidies, and reforms in health care and pensions.

2.15 Bank assistance was less effective in transportation, despite the well-formulated Transport Sector Study "*Policy Directions for Transport*" (FY99). The Study noted that Croatia's demand for transport had fallen sharply (railways and ports) or grown only modestly (roads) since the war, and that Croatia's existing transport infrastructure generally provided ample capacity to satisfy demand. It also noted that efficiency could be substantially improved, with significant scope for further privatization and commercialization. Despite this, in highways the government pursued huge increases in investment in over-designed roads[13] financed in part by expensive short term credits, which caused the Highway Sector Loan (FY95) to receive an outcome rating of unsatisfactory. Highway expenditures were moderated somewhat after 2000, but are still high. Meanwhile, maintenance on existing roads slipped badly. Problems have also emerged in railroad reforms. The ongoing Railway Modernization and Restructuring Project (FY99) seeks to improve efficiency, increase transparency of government support, reduce budgetary transfers, and prepare for privatization. However, there is as yet no progress towards establishing the legal framework for privatization, nor are there significant reductions in staff, and a large investment program has been approved by Parliament with subsidies continuing at one percent of GDP.

2.16 Results in the health sector are mixed but with distinct recent improvements. Although the outcome of the First Health Project (FY95) was rated satisfactory, this was based in large part on its support for physical infrastructure, while the project ended up doing little to assist Croatia to improve efficiency and retarget expenditures. The project did not help to target benefits better (received by 80 percent of the population), health care systems were not reformed, and transparency in health insurance was not improved. However, the ongoing Health 2 project (FY00) appears to be more useful. While the project again focused on physical infrastructure, it contained two small pilot components for reform of the provincial health systems and public health programs. With large unexpected cost savings through ICB and improved transparency, funds were reallocated to these two components. Pilot reform programs are now being implemented in many counties to enhance the role of the primary care physician, while the cost-effective public

[13] For example, unit prices for motorway construction were about 140 percent above those in Western Europe. See the Project Performance Assessment Report for Highway Sector Loan.

health system is being expanded. Finally, the SAL program helped target benefits and improve financial management in the health sector.

2.17 The Bank recognized early on that Croatia's pension system was fiscally unsustainable and supported pension reform through ESW since the mid 1990's (much of it informal) and through the SAL which supported passage of key legislation and the broadening of the wage tax base. The long-delayed Pension System Investment Project (FY02) was approved after the pension reform had been implemented, and the project is intended to support capacity building in pension supervision, registration, and the Pension Reform Institute, and financing of the initial reform years' incremental costs. It is too early to gauge results, but shortfalls in the tax system supporting pensions will need to be kept under review.

Promoting Growth

2.18 The challenge for the Bank was to assist Croatia's transformation to a market economy to sustain growth and help Croatia integrate with the economies of the EU, including meeting EU ceilings for debt. Results have been mixed over time. The 1997 CEM, which had been long delayed, noted the impressive stabilization program, but also shortfalls in implementing the structural reforms needed for growth. The CEM proposed government-led enterprise restructuring or exit for loss-making enterprises, strengthening bank regulation and supervision, introducing capital market reforms, and a retrenchment and transformation of the public sector, especially health and pension programs. It made the case that government-led SOE restructuring can be problematic, although this was nonetheless implemented with Bank support for some large enterprises. The overall impact was modest, since the government at that time was not reform-minded.

2.19 The privatization of (SOEs, and privatization and restructuring of the banking sector were supported by the EFSAL (FY97) and its associated Technical Assistance Loan (FY96).[14] Bank restructuring was a resounding success (see para. 3.8). However, privatization of enterprises was almost as resounding a failure, as detailed in paras. 3.10-12. The privatization of SMEs was flawed and has resulted in stagnation and many failures. The EFSAL also supported reforms and steps towards privatization for larger SOEs, but only the case of the public telephone company was clearly successful, although an offer for the partial privatization of the petroleum company was recently accepted. Progress in privatizing the power company has been agonizingly slow. The five large, unprivatized shipping companies remain a costly drain on the state, with possibly a single exception. Collectively, the large-scale SOEs generated losses equivalent to 3.5 percent of GDP during the most recent period for which data are available (1996-2000),[15] despite laying off more than one-quarter of their work force. Despite these shortcomings, the Bank did not effectively object, nor have subsequent operations yet fully addressed the shortcomings of the EFSAL. The Project Performance

[14] The First Technical Assistance (FY96) project provided consultant assistance which helped design the voucher privatization plan under which many SOEs were sold, assisted in planning to restructure SOEs for oil and gas, and provided advisory services to the Bank Rehabilitation Agency. A Project Performance Assessment Report for the EFSAL and TA loans is available.

[15] CEM FY04.

Assessment Report (PPAR) rated the outcome of the EFSAL as moderately unsatisfactory.

2.20 The Capital Markets Development project (FY96)[16] supported the Securities Depository Agency (SDA) which enjoys an expanded regulatory reach over the sale and purchase of private company assets. By contrast, the Croatian Securities Commission (CROSEC) is withering as only three companies have gone public on Croatia's securities market, partly because of shortfalls in privatization (see para. 3.12). The Investment Recovery Project (FY98) provided a line of credit to four banks to provide liquidity and improve management. Its outcome was rated moderately satisfactory.

2.21 The SAL (FY02) supported a large number of reforms including strengthening market institutions (i.e. a new company law) and the competitiveness of the economy (including passage of a new bankruptcy law), and enhancing flexibility in the labor market by supporting, for example, legislation to limit compensation for group layoffs to the equivalent of 6 months wages. The loan has closed after disbursement of the second tranche in October 2003, and outcome was rated as satisfactory.

2.22 FIAS' report "*Administrative Barriers to Foreign Investment*" (FY01) was a good companion to the SAL that identified barriers to foreign investment and proposed specific solutions and institutional reforms. A committee chaired by a Deputy Prime Minister managed implementation, and about 80 percent of the agenda has been approved, although implementation of some measures such as updating the land registry will take years to complete.

2.23 Other Bank lending also addressed the challenge of sustainable growth. The Bank assisted agricultural development with the Farmers Support Services Project (FY96) that supported research and seed development together with a training component to enhance policy analysis. This project was successful in its narrowly defined purview,[17] and improved policy analysis supported by the project was important in revising the income support scheme to divorce it from production and focus it on family farmers. The Istria Water Supply project achieved its objective of improving infrastructure needed to accommodate increasing levels of tourism, as well as local demand. IFC has been active as described in box 2.1 below. For more detail, see attachment 2.

2.24 A National Environmental Action Plan (FY02) would have been more useful had it more clearly identified key priorities needed to satisfy requirements for EU membership. This was later more clearly done in the FY04 CEM.

Improving Public Administration and the Judiciary

2.25 Although identified as an early priority, Bank support for sector reforms materialized only recently. A Judicial/Regulatory Reform project, which had been

---

[16] The PPAR for the EFSAL, the associated Technical Assistance loan and the Capital Markets Development project is available.

[17] The Bank had proposed an Agricultural Sector Adjustment Loan in the CASs, but government did not respond positively.

proposed for FY01, was not implemented, and, in its place, a LIL, the Court and Bankruptcy Administration Project (FY01), is now being implemented. It seeks to improve the capacity of the commercial courts through better technology and training, supporting an improved regulatory framework for trustees, and improving the professionalism, competence and integrity of commercial court judges and trustees, and to provide lessons for more wide-ranging reforms in the future. The Real Property Registration and Cadastre Project (FY02) aims to improve the agricultural land market by addressing operational efficiency in selected land offices and improving consistency between data in the cadastre and land-books.

Box 2.1: IFC AND MIGA

IFC's committed portfolio as of October 2003 was US$97.5 million, in addition to which IFC has helped its clients mobilize about US$98 million in syndicated loans, to support bank financing of SMEs, a box and cardboard company; Pliva, the largest pharmaceutical company in Central and Eastern Europe; Croatia Capital, a venture capital fund. Projects have generally been successful. Although the investment climate has been improving, a number of impediments to FDI remain (see paragraph 3.4 and attachment 2) and most FDI does not go to greenfield investments. Technical assistance includes the FIAS report and support for the new leasing law.

MIGA extended three guarantees to Austrian banks totaling $78.6 million to expand the leasing capacity of a subsidiary branch in Croatia, and to develop lending through Slavonska Banka to SMEs in tourism, agriculture, agribusiness, wood processing, and business materials. Croatia might have benefited from a larger MIGA program, but as Croatia moves towards joining the EU, the window is narrowing for this kind of useful role.

Source: IFC and MIGA.

2.26 A recent internal assessment on country procurement found that Croatia has well-established public institutions, and an effective public procurement law and public procurement administration. However, it also found that a detailed evaluation system needed to be developed since bids were evaluated largely on the basis of price, that guidelines on contract negotiations should be prepared and issued to procuring entities, and that the procurement profession should be included formally as a career stream in the civil service framework and improved training made available. Procurement problems remain, especially for large projects, some of which escape standard procedures.

2.27 The *Croatia Country Economic Memorandum* (FY04) presented a comprehensive agenda of reforms needed to improve Croatia's approach to the EU, including measures to improve governance, depoliticize public administration, and improve capacity and coordination. It is too early to gauge impact, but the proposals are well targeted to the issues facing Croatia. Finally, Croatia has received IDF grants aimed at building capacity for monitoring judicial efficiency and strengthening budget management, but with delays in approval and the recent change in government, benefits are yet to materialize.

Social Welfare and Poverty Reduction

2.28 The *Economic Vulnerability and Welfare Study* (FY00) was concluded after many years of delay by the government. It found that poverty measured by the standard for transition countries at US$4.30 per day was 4 percent, which relatively small amounts of well-targeted expenditures could substantially reduce. Poorly educated individuals and

the elderly comprised important segments of the poor. Excessive employment regulations and the high direct costs of employment (including large mandatory packages for layoffs) constrained the labor market and added to unemployment and poverty. The SAL assisted Croatia by supporting reduction in regulations and costs of employment and by supporting the elimination of arrears in social assistance and the improved targeting of child allowances. The pension reforms and capacity building described above should have some impact on the elderly poor who do receive pensions, but many of the elderly poor do not benefit from pensions.

Resource Mobilization and Aid Coordination

2.29 The Bank has worked closely with other donors. Coordination is especially close with the EU, whose support through the Community Assistance for Reconstruction, Development, and Stabilization (CARDS) program has played an increasingly important role in reconstruction, judicial and governance reforms (see box 4.2). In working to develop support for education reform (as discussed in the FY04 CEM), coordination with the EU's support of vocational education has been useful. EBRD lending to Croatia is at about the same level as the IBRD, and it has been active in privatization of SOEs, financial sector development, and municipal and infrastructure investments. EBRD officials stated that coordination with IFC is good, but that it could be improved with the Bank, although the Bank's work on legislation and regulation has been very helpful.

2.30 During the 1990s, bilateral assistance was quite limited, although Japan provided some grant funds for technical assistance and preparation of Bank projects, while GTZ of Germany focused on technical assistance for the financial and enterprise sectors. After 2000, bilateral assistance increased substantially. USAID has been very active in areas such as judicial/legal reform, although the program is expected to wind down in the next few years, in view of the actual and expected increase in the role of the EU. Earlier issues which had emerged regarding coordination with the Bank's Court and Bankruptcy Administration Project have been overcome and cooperation is now very good. DFID and GTZ are also providing assistance for legal reform. DFID also supports reforms in the health and social protection sectors. The Bank has also worked closely with NGOs such as Catholic Relief, which has been important in refugee programs associated with reconstruction, and Open Society which focuses on improving voice and accountability, as well as in aspects of education reform.

2.31 The government plays the main role in aid coordination, a positive development, and the Bank has worked closely with the government in this regard. The Ministry of European Integration (MEI) plays the key role, with a permanent working group, chaired by a Deputy Prime Minister, with the MEI as secretariat, which now covers all state-run projects. In addition, the Ministry of Finance coordinates with the IFIs, while the Ministry of Foreign Affairs coordinates with the bilateral donors.

3. Assessment of the Development Impact of the Bank

3.1 The Bank has been active in all three areas identified earlier as being in need of substantial reform. In public expenditure management, the Bank's assistance has had little impact in improving the efficiency of spending in highways or railroads, but has been instrumental in inducing the start of reform in energy, health, and pension programs. In the area of private sector development, shortfalls in the privatization process have been an important constraint on growth while limited progress has been made in helping reduce the budget deficit which pre-empts resources that could be used for private sector development and clouds the long-term outlook for debt sustainability. On the other hand, the Bank's assistance to strengthen the financial sector has been highly successful. Finally, the Bank's program has had some impact on selected areas of public administration, but thus far little impact in the area of judicial reform.

Containing and Retargeting Public Expenditure to Reduce the Debt Burden

3.2 The impact of Bank assistance on restraining and retargeting public expenditure has not been as strong as planned, and further reforms are needed. This section addresses sectoral issues, while systemic reforms of public expenditure management and administration are discussed in paras. 3.16-3.19.

3.3 Public expenditure on transportation comprises almost 5 percent of GDP in Croatia, versus 1.5 percent in the U.K. and France. Yet, transportation contributes only 8 percent to GDP, only marginally higher than the EU average of 6.5 percent. The U-shaped geography of Croatia and the need for a national road system is only a partial explanation. High unit investment costs for motorways based on excessive standards are a concern. Despite the Highway Sector Loan,[18] the government launched in 1998 construction of a large motorway program,[19] outside the original road investment plan agreed at the outset of the Highway Sector Loan, and consisting for the most part of uneconomic investments with low economic returns due to excessive standards for relatively low levels of traffic. The government elected in 2000 made some partially successful efforts to downsize the program, but the aggregate level is still excessive. Second, the condition of Croatia's road network either only improved marginally or was worse at the end of the project than at the beginning, depending on the precise measure used. This was mainly the result of inadequate funding for road maintenance. (Only 63 percent of roads are in good condition compared to 95 percent or more in most large Western European countries). In railroads the Bank's assistance is also not yet having the desired impact, with progress on restructuring and privatization lagging and with large subsidies (exceeding 1 percent of GDP) continuing. Recently, the government approved a large investment program, which appears to run counter to the goal of efficient privatization.

---

[18] See Project Performance Assessment Report, Highway Sector Project, Loan 38690, Report No. 28381, World Bank.

[19] Especially the Zagreb-Split motorway (which is not one of the Pan-European Corridors). Internationally recognized appraisal techniques were not used, and no assessment was provided of economic benefits.

3.4 The Bank has promoted an improved legal structure for the Energy Sector, but, substantial restructuring is yet to begin and the pace of implementing legislation is quite slow. Five major reform laws were passed in 2001,[20] but implementation schedules (except for unbundling) remain to be specified. However, the recently approved Energy Efficiency project[21] supported creation of a new energy service company to develop, finance and implement energy efficiency projects. In Environment, the Bank has had some impact through the Istria and Municipal Water Supply projects, as well as through the Forestry Reconstruction project. However, a hoped-for broader sectoral approach to environment proposed in the FY99 CAS and the CAS PR has not materialized.

3.5 Croatia spends over 7 percent of GDP on *health*, compared to 5 percent for the CEECs and 6.6 percent for the EU. While health indicators have been improving over time (see annex A, table 2) and are similar to Croatia's neighbors (see table 3.1 below), further reforms are needed to make desirable, as well as affordable, improvements towards EU standards. Primary health care is underemphasized, public health programs are lacking, and health insurance is inefficient. Recent reforms better match care to needs and public health programs are expanding, but it is too early for these reforms supported by Health II (FY00) to have had an impact. *Pension* reform is also beginning to take hold, and a three pillar pension system has been introduced. Pension expenditures still exceed 13 percent of GDP and deficits are above 4 percent of GDP, although this is reduced from 1999 when the deficit on account of pensions was more than 6 percent of GDP. Further reductions are expected with already legislated retirement age increases. Improved compliance and other reforms are still needed.

Table 3.1: Health Indicators

Countries	*Infant Mortality Rate (per 1000 live births)*	*Maternal Mortality Ratio (per 100,000 live births)*	*Incidence of TB (new cases per 100,000 per year)*	***SDR for ischaemic heart disease*	***SDR for tracheal/ bronchial/ lung cancers*
Croatia	**7.68**	**6.86***	**31.01**	**162.83**	**47.36**
Bulgaria	14.40	19.07	48.80	190.03	29.26
Czech Republic	3.97	3.31	12.63	184.20	47.55
Hungary	8.13	5.15	28.69	225.46	64.84
Poland	7.67	3.53	26.28	133.47	52.49
Romania	18.41	34.03	127.54	228.36	35.89
Slovak Republic	6.24	15.64	18.33	287.99	40.13
Slovenia	4.25	17.22	18.02	100.15	40.64
EU Average*	**4.74**	**5.62**	**11.55**	**98.12**	**37.66**
CEEC Average	**10.41**	**13.02**	**49.33**	**185.30**	**45.47**

Note. For year 2001, unless otherwise indicated;* indicates year 2000 data.
**Standardized Death Rates.
Sources: WHO EURO, Health For All database, 2003.

[20] (1) Energy Law to establish rules of accountability and transparency; (2) Law on the Electricity Market to establish the conditions for a competitive electricity market; (3) Law on Gas Markets to establish conditions for a competitive gas market; (4) Law on the Regulation of Energy Activities; and (5) Law on Oil and Oil Derivatives Market to improve access to oil and gas pipelines.
[21] Loan to the National Power Utility combined with a GEF grant.

Promoting Growth

3.6 Although GDP growth has been sustained and inflation kept low, private sector development is playing too small a role and government expenditures and deficits too large a role for growth to be sustainable. The government's fiscal balance, the current account deficit and debt need greater attention as external debt has increased from 20 percent to more than 80 percent of GDP from 1994 to 2003. The debt service to exports ratio has increased very rapidly and is now close to 30 percent (annex A, table 2). Croatia's foreign exchange reserves provide some cushion, but are no substitute for the smaller deficits needed for medium and longer-term sustainability. Foreign direct investment has not played a dynamic role in broad-based industrial sector restructuring, and industrial exports are relatively stagnant, reflecting a lack of success on the part of the Bank's assistance in privatization and private sector development. Although manufacturing exports may not play the dominant role in Croatia as in other countries because of Croatia's receipts from tourism and workers remittances, high wages do impede exports, as Croatia's wages are higher than in almost all of its closest competitors, including the Czech Republic (one-third higher), Slovak Republic (twice as high) and Bulgaria and Romania (almost five times as high).[22] On the positive side is the increase in domestic savings, despite government deficits. While FDI has not played a broad role in restructuring the economy and has been concentrated in a few large investments, it is substantial and came to 7.2 percent of GDP in 2001 and 4.0 percent of GDP in 2002, about average for CEE and the Baltic Countries (5.0 and 6.4 percent of GDP for 2001 and 2002, respectively).[23] Standard and Poor has rated Croatia's foreign currency debt as BBB-since 1997, just below Thailand, China and the Slovak Republic, but above Bulgaria.

3.7 The Bank's ESW and adjustment lending which addressed these issues were fully relevant but only partly efficacious. Government spending has not been as constrained (nor as well targeted) as recommended by the Bank. Had Bank recommendations on public sector expenditure been more fully implemented, the macroeconomic outcome would have been more positive.

3.8 The Bank, through the EFSAL, SAL, technical assistance, and ESW, has played an important role in *financial sector* reforms which have been quite successful. Financial sector reform addressed the large number of weak and undercapitalized private banks which emerged after independence, while state banks were being rehabilitated. The Croatia National Bank (CNB) implemented a program of diagnostic supervisory audits, resulting in the closure of 13 banks in 1998 and 1999.[24] Privatization of state banking began with the EFSAL-supported program in 1997, and all but two state-owned banks have now been privatized. The government has decided to privatize these last two banks and is developing a strategy to do so. The banking sector is now 92 percent foreign-owned. Most banks are well capitalized and generally compliant with the core principles for effective banking supervision. Needed further structural improvements concern

[22] Although wages are higher in Slovenia, productivity there is almost twice as high, so that labor costs are lower.
[23] EBRD *Transition Report Update*, 2003.
[24] CEM, FY04.

bankruptcy processes and creditor rights.[25] Banks face foreign exchange risk as foreign currency deposits exceed foreign currency loans, and foreign currency loans to enterprises are not matched by export earnings.[26]

Table 3.2: Financial Sector Performance

	1996	*2001*
Spread between lending and deposit rates, Kuna	14.3	6.4
Spread between lending and deposit rates, in foreign exchange	14.4	3.6
Broad Money (M4) in percent of GDP	34.0	52.0
Loan to deposit ratio*	92.6	82.0
Nonperforming assets of Banking system, percent of total assets	9.2	7.2
Bank assets in percent of GDP	62.5	74.0

*excludes government accounts
Source: FSSA.

3.9 As an overall indicator of improved financial sector competitiveness, spreads have been decreasing (see table 3.2), bank assets as a percent of GDP have been increasing, and the financial sector has been deepening as indicated by the increase in broad money as a percentage of GDP. The Financial System Stability Assessment found that the financial system is now more resilient and can absorb moderate macroeconomic stresses, that banks are generally well capitalized, nonperforming assets have decreased as a fraction of total assets, and that supervision is acceptable though aspects could be strengthened. Croatia merited a 3+ rating for banking reform in the EBRD's Transition Report for 2001, as did Latvia, Poland, and Slovenia and just below top-rated Hungary, Estonia, and the Czech Republic.

Table 3.3: Private Sector Share of GDP

Country	*1994*	*Mid 2002*
Croatia	40	60
Bulgaria	40	75
Poland	55	75
Romania	35	65
Slovenia	30	65

Source: EBRD Transition Report Update 2003.

3.10 Progress in private sector development is much less positive, despite the EFSAL's and (much more recently) the SAL's strong focus on this sector.[27] Croatia's private sector accounts for only 60 percent of GDP. Even though many transition countries started out with similar rates of private sector participation in GDP, Croatia's private sector is now one of the smallest as a percentage of GDP.

3.11 The low private sector share of GDP is the result of disparate trends for the three enterprise subsectors. First, the newly established private enterprises are dynamic with value added increasing from 9 percent to 16 percent of GDP between 1996 to 2000. These are mostly small scale, although with some recent increase in average size. Second, and in contrast, the privatized SOEs' contribution to GDP shrank, albeit marginally, from 14 percent of GDP to 13 percent. Finally, the remaining SOEs' value added declined from 10 percent to 7 percent of GDP.

3.12 Privatized SOEs have been stagnant because privatization was problematic. Privatization processes have been cumbersome and confusing. Of even greater concern,

[25] "*Republic of Croatia: Financial System Stability Assessment*", IBRD/IMF, August 2002.
[26] The problems of managing a mixed-currency system were highlighted recently with the very large inflow (about US$2 billion) into the banking system when Croatians deposited DMs "mattress savings" as DMs were converted to Euros, which then led to a large increase in bank lending which was difficult to contain.
[27] Reforms supported by the SAL are too recent to have had an impact on available data.

the State Audit Agency found serious irregularities in four-fifths of 500 cases examined. Insider buyouts, heavily favored under Croatia's privatization program, frequently led to corrupt and inefficient outcomes, including stripping of assets which should have been turned over to the Croatian Privatization Fund (CPF) for auction; repayment of debts incurred by shareholders from company funds; illicit use of company assets to collateralize and guarantee private mortgages; and failure by the CPF to terminate company supply contracts on which private payments were in arrears.[28] Four hundred and thirty privatized enterprises have reverted to public ownership by the CPF,[29] and many others may follow since the CPF holds additional share-purchase contract commitments with 96,000 employees of privatized SOEs. Nearly 40 percent of these privatized enterprises remained unprofitable for 1996-2000.[30] While the new private sector enterprises account for an increasingly large proportion of GDP, delay in reforms, including implementation of many recommendations of the FIAS report, strongly suggests that progress could have been much more rapid. The EFSAL impact on PSD has not been satisfactory either regarding the privatization of SME SOEs or reforms/privatization of the large SOEs.

3.13 The privatization agenda is clearly not yet finished and there remains a substantial adjustment/transformation yet to be accomplished. The roles and responsibilities of the CPF need to be more clearly defined, and CPF needs stronger support from the government.[31] Programs and institutions that support SOEs are still not transparent and their impact is difficult to assess. They still receive preferential treatment, avoid hard budget constraints, and generate large losses. Finally, exit is inhibited since the bankruptcy system does not work well because of large backlogs in the courts, lack of well-trained trustees, and lack of a regulatory framework which would allow trustees to work effectively. These are the issues which the Bank's Court and Bankruptcy Administration Project (FY01) is beginning to address.

3.14 Despite these shortfalls, the reforms supported by the SAL should have a substantial impact on private sector development in the future. The improved Company Law strengthens minority shareholders' rights and liberalizes rules which had hindered share transfers, among other reforms, while some barriers to domestic and foreign investment have been alleviated.[32] Amendments to the bankruptcy law strengthen creditors' rights and bolster courts and related institutions. A new streamlined rules-based, fixed fee business licensing and registration procedure, including a one-stop shop entity, has been established. For the remaining SOEs, the government publishes quarterly accounts, ensures cash payments for all government purchases from these enterprises, and require that SOE accounts receivable and payable are kept current.

---

[28] These and other issues concerning privatization are discussed more fully in the PPAR for the EFSAL.
[29] The CPF still manages about 1,200 enterprises, of which 175 are majority owned, including major enterprises in shipbuilding, agriculture, and tourism.
[30] CEM FY04.
[31] The CPF recently was left without a chief executive for 16 months.
[32] Administrative procedures related to investor entry and expatriate employment have been simplified, and the time required to process visas and work permits has been reduced, among other reforms.

3.15 In agriculture, the Bank has had a modest but useful impact with the Private Farmer Support loan which was targeted to research and training, as well as the cadastre project. The agrokombinats remain a major problem that has as yet been ineffectively addressed by the Bank's ESW. Improvements are also needed to enhance the performance of private sector agriculture. Subsidies are high compared to accession countries (and now amount to 4.4 percent of the central government budget, an increase from 2 percent in 1995-98), although producer price supports are similar to those in the EU. Bank support for improved land markets under the ongoing Cadastre project is too recent to be evaluated.

Improving Public Administration and the Judiciary

3.16 *Public administration* efficiency should be improved by realigning ministries and strengthening policy management. The government's core functions in key ministries such as the Ministry of Finance need to be strengthened, including policy development and determination of reform priorities. Conversely, the government still plays a larger role than appropriate in many sectors including energy, transportation, agriculture, and industry. Political appointments extend through many levels rather than being restricted to the very highest levels in each ministry. The FY04 CEM sensibly proposed that political appointments should be limited to the Ministerial and Deputy Ministerial levels, as widespread political appointments deprive ministries of much-needed technical expertise. The public administration wage bill is high at 11.9 percent of GDP, compared to 9.9 percent in Slovenia,[33] 9.5 percent in the Czech Republic,[34] and 9.1 percent in the Slovak Republic.[35] The government enacted several wage freezes which were only partly successful, despite Bank proposals in the PEIR (FY02) and other ESW for selective wage controls which would have promoted restructuring. Overall staffing is not excessive.[36] The SAL supported implementation of some priority reforms to improve governance, such as to bring all sources of revenue and expenditures on-budget beginning in 2002 (although highway funds are treated specially). Municipal government "reforms" in 1995 increased the number of municipal governments from the 104 that existed at independence to more than 424, in addition to which there are 123 towns, and the city of Zagreb. Most municipalities have populations below 3,000. Despite a fairly broad list of powers, funding remains highly centralized; the Bank has noted that substantial gaps exist between the two, and that Croatia should take a position on amalgamation of local governments, but as of now, none has been forthcoming.[37]

3.17 Although judicial reform is one of three key areas in which the EU has stated that progress is needed if Croatia is to move closer to accession negotiations,[38] there is to date only halting progress. The Bank should focus more on supporting reforms that enhance

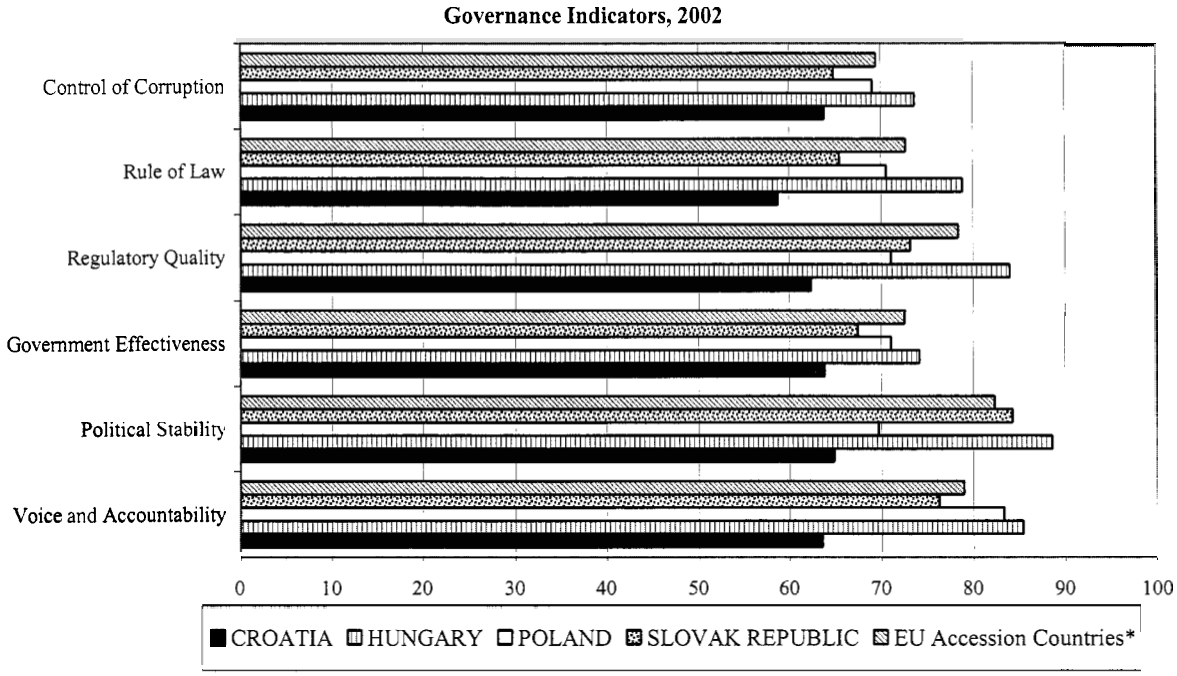
---

[33] IMF Article IV Consultation, 2003
[34] IMF "*Czech Republic: Selected Issues and Statistical Appendix*", January, 2004
[35] CEM FY04.
[36] Staff in central and general government comprises 4.9 percent of the population, in line with a sample of seven comparable countries. However, it appears that the non-civilian public sector may be relatively large, and as security concerns continue to be addressed through non-military means, this could be reduced.
[37] CEM FY04.
[38] The others are to speed up refugee return and full cooperation with the The Hague tribunal.

incentives for improved performance including timely settlement of cases, improved access to precedents, computerization, expanded roles for bailiffs, wider use of and upgrading of trustees, and use of administrative courts to settle issues such as wages.

3.18 While most cases of *public procurement* appear to be satisfactory and the recent internal assessment on country procurement covered the basics for project procurement, there are at least several instances of larger-scale government projects which raised procurement issues, including in the Highway Sector, and, reportedly in other sectors. It would be important for the next country procurement assessment to look into these issues to assess the effectiveness of the procurement framework as it applies to all projects, large and small.

3.19 Croatia ranks below the EU accession countries in the key governance indicators, especially in rule of law, political stability, and voice and accountability, as shown in the chart below, and well below Hungary, Poland, and the Slovak Republic in each of these areas. Croatia will need to improve its governance indicators as part of its efforts to enhance relations with EU and EU accession countries.



Source: Kauffman, Kraay, and Mastruzzi, "Governance Matters III", World Bank, 2003
*Excluding Cyprus and Malta, for which no data are available.

Poverty Alleviation and Unemployment

3.20 The Bank has been less active in poverty alleviation and social development than would have been desirable, largely because until 2000 the government did not welcome Bank assistance in this area. The Economic Vulnerability and Welfare Study (FY01) was long-delayed, having been on the agenda since the mid-1990's country strategy. While

the Bank supported pension and other social sector reforms (see above), it has not yet had a strong impact on poverty alleviation. For the future, the labor market reforms supported by the SAL should have an important impact on poverty and unemployment. While the Bank is beginning to have an important impact in health, it has not been active in education, identified as a weakness in the Vulnerability Study, and where a proposed project was dropped from the lending program, because of lack of interest on the part of the government. Finally, both the first and the second client surveys (see box 4.1) indicated that the Bank was not perceived as being involved to any great extent in poverty alleviation or unemployment.

Outcome of the Country Assistance Program[39]

Relevance

3.21 The Bank proposed relevant assistance programs in the two CASs and the CAS PR. However, prior to FY02, the assistance program as implemented was less relevant, as the government turned aside proposals for adjustment and sector reforms in public administration, the judiciary, health, and other sectors. In addition, as noted in para. 2.5, the Bank at times limited access to adjustment assistance because of concerns about Croatia's financial support for Bosnian Croats in Bosnia and possible destabilization there. The resulting lending program focused much more on infrastructure than the CAS proposals, and less on reform needed in public expenditure, debt, growth, and governance. Since FY02, relevance has improved substantially as the focus has shifted to the needed reforms, especially with the implementation of the PEIR, the Vulnerability Assessment, the SAL, and the Bankruptcy LIL. Most recently, the Bank's activities to promote closer relations between Croatia and the EU have been fully on target, as illustrated, for example, by the proposals presented in the FY04 CEM.

Efficacy

3.22 Efficacy through FY01 was low, with many attempts to influence policy achieving only little success, so that even proposed analytic pieces (investment reviews, poverty assessment) were sidelined by the government; results in the project portfolio were mixed with specific shortfalls in key operations including the Highway sector loan and the EFSAL. Despite this lack of efficacy and shortfalls in achieving CAS objectives, the Bank did not reduce the proposed level of lending in the FY99 CAS. In the event, actual lending fell far short. Efficacy after FY01 has improved and is rated substantial with the implementation of the SAL-supported program, the ongoing Health 2 project and the impact of ESW, among other activities.

Summary Rating of the Outcome of the Bank's Assistance Strategy

3.23 Bank actions, which largely determine Bank performance, are only one contributor to the outcome and institutional development impact of the Bank's assistance strategy. Outcomes are also determined by the Borrower's performance and other

[39] For a description of rating methodology, see annex D "Guide of OED's Country Assistance Evaluation Methodology."

factors. The outcome of country assistance through FY01 is rated unsatisfactory, as the government did not accept the need for key reforms proposed by the Bank as evidenced by the deterioration of public expenditure performance, the continuing rise in debt, lack of reforms in public administration and governance, and lack of progress in reducing poverty and addressing unemployment, and in the case of privatization, lack of progress in generating sustainable growth through privatization programs which were in part supported by the Bank. These evaluations are supported by the outcome ratings for completed projects, and the large mismatch between proposed and implemented assistance programs. The post FY01 program is rated satisfactory, based on higher ratings of relevance and efficacy. There has been progress in restraining and retargeting the public investment program, in SAL-supported reforms, and in public administration and governance reforms, although the latter are proceeding at a slower than desirable pace. Finally, ratings for ongoing projects are better for Croatia than for ECA and the Bank as a whole.

Institutional Development Impact

3.24 Institutional Development Impact (IDI) is rated high for financial sector soundness, where the impact on institutions through the EFSAL and ESW has been strong. Concerning economic management, IDI through FY01 was modest, but subsequently it is rated substantial, as a result of the impact of the PEIR and the SAL. Bank assistance has not yet had much of an impact on the structure of the public sector, and IDI here is rated as modest for both time periods. The Bank has had a substantial institutional development impact on aid coordination, for which an IDI rating of high is appropriate. An IDI rating of substantial is appropriate for financial accountability, although there is a need for improvement in the way some large projects are handled. In general, where the Bank was able to implement work with substantial policy content in a receptive sector, IDI was high. With lesser policy content in less receptive sectors, IDI was lower. Overall, IDI is rated as modest prior through FY01 and substantial for subsequent years.

Sustainability

3.25 The uniformly high ratings for sustainability among project ratings, and, even more important, the anchoring of Croatia's programs in its aspirations to join the EU and to work ever more closely with EU countries, suggest a rating of likely for sustainability. However, Croatia's high debt, and the need for accelerated progress in privatization, governance, and other reforms needed to sustain growth, introduce a strong note of caution concerning sustainability. Further reforms are clearly needed.

4. Contributions to Outcomes

World Bank Contributions

4.1 The objectives of the Bank's assistance program were relevant to the development challenges facing Croatia. However, from FY94-FY01, the program actually implemented was quite different from that proposed. There were two reasons for this. First, reconstruction emerged as a continuing challenge and the Bank appropriately restructured the proposed program to address this challenge by adding three reconstruction projects to the program. On the other hand, relevant public sector and agricultural adjustment loans were not implemented. The government was not ready to accept a poverty assessment during the 1990s so that this could not be implemented, and, similarly, the CEM was delayed. Even so, the Bank/Client dialogue was sustained to some extent, financed in part by TA grant funds in preparation for (subsequently dropped) adjustment lending but yielding some reform proposals that were later implemented. The divergence between expected government receptivity to reform and government performance during the 1990's is captured by the projected role of government in GDP in the mid-1990's country strategy, in which government expenditures were projected to peak at about 30 percent of GDP, only slightly more than half of the percentage actually reached.

4.2 Subsequent to FY01, the proposed assistance strategy has been both relevant to the challenges facing Croatia and implemented largely as projected in the CAS PR. ESW (the PEIR, CEMs, "*Croatia: A Policy Agenda for Reform and Growth*") contributed to this positive outcome, with the SAL providing important operational support.

4.3 The Bank's role as suggested by client surveys (box 4.1) appears to have been more important in implementing projects with appropriate safeguards, than in reducing poverty or improving governance.[40]

Box 4.1: Client Surveys

The 1998 client survey respondents reported that the Bank's most important contribution was to foster growth while the least important was to help strengthen civic participation. The Bank was seen as most effective in supporting infrastructure, least in alleviating poverty. Respondents thought the Bank was realistic and highly effective in adjusting to changing country circumstances, but that the Bank needed to be more active in restructuring poorly performing projects. The 2003 Client Survey found that Croatians view the Bank's work in safeguarding against corruption in projects and programs that it funds with its procurement rules as its most important activity, while the least important activities are helping to reduce poverty and gender disparities. The Bank was found to be least effective in strengthening education and the judicial system (but that strengthening the judicial system was a high priority), and was most effective in strengthening infrastructure. The Bank was given high marks for the way it handles disbursements and other project-related activities. The most room for improvement was in helping to strengthen the economy, jobs/employment, education, reducing corruption and improving governance, and strengthening the judiciary. The Bank was also credited with going public with its attitudes toward Croatia, and making the results of its activities known publicly. Many felt that the Bank exhibited correctness, clear rules, and measurability of attainments. There was a feeling among those with negative attitudes that the Bank's real interests are hidden, and that it is blackmailing small countries such as Croatia on the part of the big ones.

[40] For methodology of the client surveys, see attachment 3.

Client Country Contribution

4.4 Through FY01, Croatia was faced with regional conflicts and was torn between choosing inward and outward-looking development paths. Although the Bank was seen as an important bridge to Western Europe, the reform messages brought by the Bank, through formal and informal ESW were often not well accepted. This ambivalence is reflected in unfulfilled CAS programs and halting efforts at reform which resulted in increasing government participation in the economy, large budget deficits, and a degree of economic instability. Subsequent to FY01, the country has been much more clearly focused on joining the EU and reforming its economy accordingly. But the change would have been more complete if Croatia had also addressed the faulty privatization programs, the large role for politics in public administration and efficiency, and effectiveness of public administration. The highway program remains an important issue for public finance reform, despite some improvements since 2000, and there are shortcomings in education which impinge on social development. Despite these drawbacks, there is general agreement in Croatia on pursuing reforms to enable it to join the EU. The key question is whether implementation of reforms can be accelerated so as to make more realistic the country's ambition to join the EU in the next few years.

Aid Partner Contributions

4.5 The Bank has worked closely with the IMF in assisting Croatia. The IMF's first two programs were not completed (Croatia only drew on the Standby Arrangement (SBA) approved in 1994 and the Extended Fund Facility approved in 1997 for the initial drawings and then allowed the programs to lapse with very partial implementation), which reflects a close parallel in the Bank's unsuccessful attempts to promote structural reforms during these years. However, the SBA approved in 2001 and the ongoing SBA, approved in 2003, have been successful in terms of program implementation and technical assistance,[41] and have complemented the program supported by the SAL.

4.6 Croatia has in the last few years benefited from substantial assistance from the EU's CARDS program (see box 4.2) and from the national dialogue which is supporting Croatia's efforts to join the EU, spurred by the SAA. This is now an important lynchpin for all other assistance programs. The EU is supporting a variety of programs including refugee assistance and vocational training, and plans to support state audits to improve privatization performance. EU organizations such as Support for Improvement in Governance and Management (SIGMA) have also been important.

4.7 USAID has played a key role in furthering reforms supported by the Bank's assistance program. USAID support for judicial reform, governance, capital markets development, treasury, pension reform, and the cadastral survey in Zagreb, have all been important in this respect. USAID has funded SAL counterpart staff, thereby removing an important constraint to SAL implementation. When disagreements did emerge, as in studies for judiciary reform relevant to the Bank's Bankruptcy and Court Administration project, they were resolved. Similarly, the British Know-How Fund provided financing

[41] These SBAs were based on programs agreed between Croatia and the IMF, but did not involve financial assistance.

for technical assistance for EFSAL implementation. The Bank's assistance for reconstruction was furthered by a number of bilaterals and by NGOs, such as the Catholic Relief Services, and the Open Society Institute-Croatia.

Box 4.2: European Union Assistance

The EU CARDS program allocates about 60 million Euros per year to Croatia, which have been used to support 16 projects in 2001, 29 in 2002, 39 in 2003. The EU Ambassador to Croatia sees the World Bank as having an important role, and relations with the local office are very close. There are important overlapping areas of interest related to the Bank's lending program including reforms of public administration, the legal system and its implementation, and cadastral improvements. Non-lending activities have also been important. Concerning war recovery, the EU identified counties in Dalmatia which were severely impacted, and the Bank supported Regional Development Workshops on these counties, which helped the EU to formulate programs in these counties, which should be good models for the other counties. SIGMA (a joint venture of OECD and EU Phare) analyzed public administration and made recommendations as reported in the CEM (FY04) which would also serve as a good basis for Bank-supported reforms in the future. The EU Ambassador also felt that the Bank has an important role to play in improving health and education strategy and programs, although the EU takes leadership in vocational training. EU also focuses on support for refugees and building capacity of local governments to prepare for Regional Funds. Public opinion polls show that 70 percent of Croats want to join the EU. As preconditions to opening negotiations on EU membership, Croatia needs to completely satisfy 3 political conditions: full cooperation with the Court of International Justice in The Hague, speeding up return of refugees, and progress on judicial reform. Negotiations need to be opened by 2004 if there is to be any hope of joining the EU in 2007.

4.8 EBRD has played a useful role in its numerous investments with its collaboration with IFC on specific projects. It has also assisted the private sector development goal more broadly by supporting programs to develop entrepreneurship and in helping to reform selected public enterprises.

Impact of Exogenous Factors

4.9 The downturn in the world shipping industry had a serious impact on Croatia's shipyards and made their sale, agreed under the EFSAL, difficult. The conflict in Kosovo was exogenous and greatly reduced tourism for several years, although by now tourism has fully recovered. On the positive side, EU Accession agreements by many of Croatia's neighbors have an important demonstration effect re-enforcing the depth of actions to support Croatia's goal of joining the EU. Conversely, the earlier entry of neighbors, at least until Croatia could join the EU, might divert some potential FDI away from Croatia.

5. Lessons and Recommendations

5.1 A lesson from the pre-FY02 program, and especially the unsatisfactory outcome of privatization and the EFSAL, is that the Bank needs to be clear about government support for adjustment operations, closely supervise them, and modify/cancel them if necessary, rather than to allow faulty implementation to proceed. For countries aspiring to accede to the EU, the Bank also needs to develop the case at the highest levels more clearly for health and education reform, where these and related aspects of social development are not directly addressed by EU programs. Conversely, large projects for infrastructure, such as the Highway Sector Project, are not necessarily beneficial in the absence of policy reform as signaled by the lack of a firm tie-in to an adjustment program. Large infrastructure sector or investment operations should not substitute for adjustment operations to make up for shortfalls in lending programs.

5.2 Moderate GDP growth based on factors such as tourism and workers remittances can hide, at least for a time, problems in transformation of productive sectors, especially where GDP is recovering from depressed levels due to war, as happened in Croatia. Since the case for adjustment can be difficult to make in these circumstances, it needs to be based on solid ESW, including informal ESW where necessary, and presented convincingly at the highest levels. The successful financial sector reform is instructive, where this case was made to the National Bank.

5.3 For privatization, the key lesson is that insider buy-outs should not be favored or given special incentives which may make corrupt outcomes more likely. Guaranteed buy-backs further undermine the quality of privatization, and leave the problem unresolved. Market-based opportunities to purchase enterprises should be widely available to promote competition in the purchase of assets.

Recommendations

5.4 The forthcoming country assistance strategy should set out the key reforms needed for Croatia to successfully pursue membership in the EU. The FY04 CEM already provides a good outline for this agenda, which should focus on a fiscally responsible and well-targeted role for government, improved governance and judiciary reforms, pursuing the privatization agenda, and the health and education reforms needed to bring Croatia towards EU standards.

5.5 The Bank should support rationalizing and retargeting public expenditure, in line with public revenues, to support reforms in health, education, and infrastructure. In so doing, special care should be taken in the transportation sector. The disappointing outcome of the Highway Sector Loan and continuing lack of adherence to appropriate standards (despite some improvements) and maintenance have resulted in highways continuing to absorb large amounts of resources needed for other higher priority programs. Lack of progress on the Railways Modernization project to date raises a similar concern. Consideration could be given to making a large component of the lending program conditional on effective reforms in public investment, for which the transportation sector would be an important example.

5.6 A second focus of Bank assistance should be improving growth, attacking unemployment and strengthening debt sustainability by promoting private sector development. One aspect of this would be to ensure that privatization of SOEs or reprivatization of failed enterprises is successful, e.g., does not favor insider buyouts. A second aspect would be to monitor the SAL-supported reforms, aimed at improving the environment for private sector development, in order to assess whether further measures are needed.

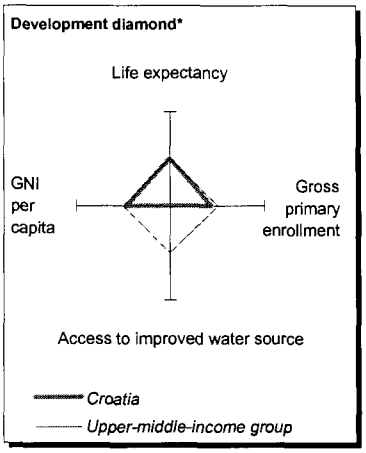
5.7 Finally, the Bank's assistance should focus on improving the core functions of government, public administration, and the judicial sector.

Annex A: Statistical Annexes

Annex Table 1: Croatia at a Glance

8/20/03

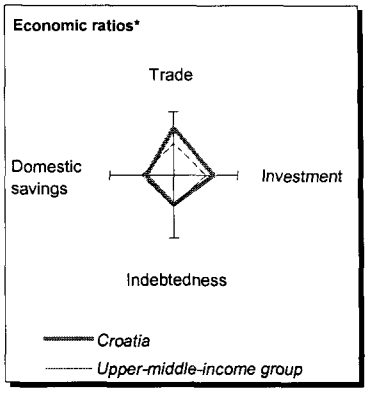
POVERTY and SOCIAL	Croatia	Europe & Central Asia	Upper-middle-income
2002			
Population, mid-year *(millions)*	4.4	476	331
GNI per capita *(Atlas method, US$)*	4,640	2,160	5,040
GNI *(Atlas method, US$ billions)*	20.3	1,030	1,668
Average annual growth, 1996-02			
Population *(%)*	-0.6	0.1	1.2
Labor force *(%)*	-0.4	0.4	1.8
Most recent estimate (latest year available, 1996-02)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	59	63	75
Life expectancy at birth *(years)*	74	69	73
Infant mortality *(per 1,000 live births)*	7	25	19
Child malnutrition *(% of children under 5)*	1	..	..
Access to an improved water source *(% of population)*	..	91	90
Illiteracy *(% of population age 15+)*	2	3	7
Gross primary enrollment *(% of school-age population)*	91	102	105
Male	92	103	106
Female	91	101	105



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

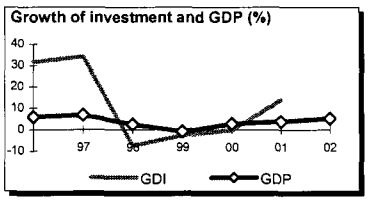
	1982	1992	2001	2002
GDP *(US$ billions)*	..	10.2	19.5	22.4
Gross domestic investment/GDP	..	13.4	24.7	..
Exports of goods and services/GDP	..	59.6	48.5	..
Gross domestic savings/GDP	..	18.9	18.4	..
Gross national savings/GDP	..	16.3	20.7	..
Current account balance/GDP	..	..	-3.2	..
Interest payments/GDP	..	..	3.2	2.5
Total debt/GDP	..	..	55.7	59.9
Total debt service/exports	..	..	27.6	..
Present value of debt/GDP	..	..	54.8	..
Present value of debt/exports	..	..	99.8	..

	1982-92	1992-02	2001	2002	2002-06
(average annual growth)					
GDP	..	3.6	3.8	5.2	4.0
GDP per capita	..	4.7	3.8	5.3	4.3
Exports of goods and services	..	5.9	9.0	..	..

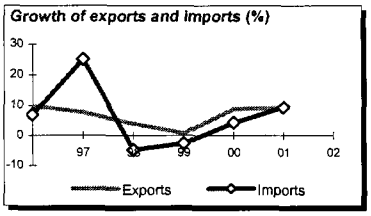


STRUCTURE of the ECONOMY

	1982	1992	2001	2002
(% of GDP)				
Agriculture	..	14.9	9.7	..
Industry	..	33.1	34.2	..
Manufacturing	..	29.2	24.3	..
Services	..	52.0	56.1	..
Private consumption	..	57.3	56.6	..
General government consumption	..	23.8	25.0	..
Imports of goods and services	..	54.2	54.7	..



	1982-92	1992-02	2001	2002
(average annual growth)				
Agriculture	..	-0.1	0.7	..
Industry	..	2.7	4.3	..
Manufacturing	..	2.1	6.0	..
Services	..	4.4	4.8	..
Private consumption	..	2.7	4.6	..
General government consumption	..	0.4	-3.9	..
Gross domestic investment	..	7.6	13.7	..
Imports of goods and services	..	4.8	9.3	..



Note: 2002 data are preliminary estimates.

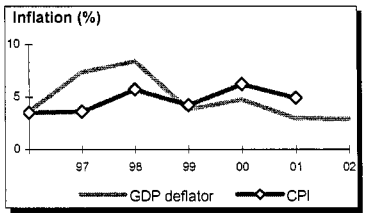
This table was produced from the Development Economics central database.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Croatia

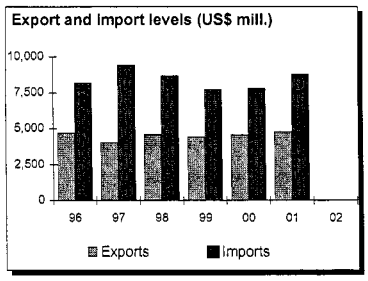
PRICES and GOVERNMENT FINANCE

	1982	1992	2001	2002
Domestic prices				
(% change)				
Consumer prices	..	663.6	4.9	..
Implicit GDP deflator	..	594.9	2.9	2.9
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	35.0	46.0	46.8
Current budget balance	..	-2.1	-1.6	2.2
Overall surplus/deficit	..	-3.7	-3.9	-5.1



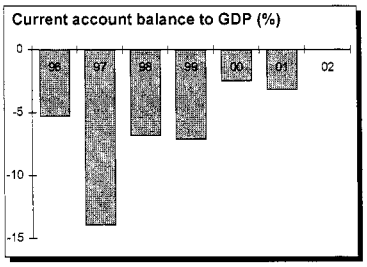
TRADE

	1982	1992	2001	2002
(US$ millions)				
Total exports (fob)	..	4,445	4,752	..
Raw materials, excluding fuels	..	286	241	..
Mineral fuels and lubricants	..	397	474	..
Manufactures	..	1,878	2,393	..
Total imports (cif)	..	4,461	8,764	..
Food	..	314	691	..
Fuel and energy	..	418	1,174	..
Capital goods	..	468	3,005	..
Export price index *(1995=100)*	..	..	150	..
Import price index *(1995=100)*	..	..	149	..
Terms of trade *(1995=100)*	..	..	101	..



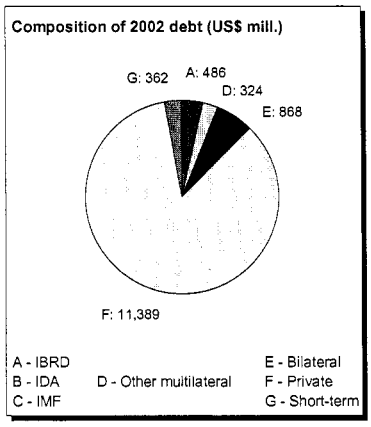
BALANCE of PAYMENTS

	1982	1992	2001	2002
(US$ millions)				
Exports of goods and services	..	6,107	9,625	..
Imports of goods and services	..	5,547	10,659	..
Resource balance	..	559	-1,034	..
Net income	..	-170	-529	-457
Net current transfers	..	-91	966	..
Current account balance	..	..	-617	..
Financing items (net)	..	..	1,930	..
Changes in net reserves	..	-167	-1,313	..
Memo:				
Reserves including gold *(US$ millions)*	..	167	4,704	..
Conversion rate *(DEC, local/US$)*	..	0.3	8.3	7.9



EXTERNAL DEBT and RESOURCE FLOWS

	1982	1992	2001	2002
(US$ millions)				
Total debt outstanding and disbursed	..	..	10,888	13,429
IBRD	..	..	427	486
IDA	..	..	0	0
Total debt service	..	..	2,966	3,310
IBRD	..	..	37	51
IDA	..	..	0	0
Composition of net resource flows				
Official grants	..	..	67	..
Official creditors	..	..	16	5
Private creditors	..	..	718	1,101
Foreign direct investment	..	..	1,512	..
Portfolio equity	..	..	6	..
World Bank program				
Commitments	..	..	5	53
Disbursements	..	..	75	33
Principal repayments	..	..	18	30
Net flows	..	..	57	3
Interest payments	..	..	19	21
Net transfers	..	..	38	-18



Note: This table was produced from the Development Economics central database. 8/20/03

Annex Table 2: Croatia - Key Economic and Social Indicators, 1990-2002

	CROATIA																				
Series Name	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*Croatia*	*Czech Rep*	*Estonia*	*Europe & C.Asia*	*Hungary*	*Poland*	*Slovak Rep*	*Upper middle inc*
GDP growth (annual %)	..	-21.09	-11.71	-8.03	5.87	6.83	5.90	6.80	2.52	-0.86	2.86	3.77	5.23	**-0.16**	0.62	-0.52	-0.73	0.97	3.29	0.82	2.74
GDP per capita growth (annual %)	..	-21.25	-11.66	-7.99	5.89	10.11	8.46	8.70	3.69	-0.36	2.73	3.75	5.32	**0.62**	0.74	0.58	-0.93	1.14	3.18	0.66	1.36
GNI per capita, Atlas method (current US$)	..	..	..	2,420	2,530	3,410	4,240	4,750	4,730	4,560	4,500	4,410	4,640	**4,019**	4,606	3,394	2,121	4,089	3,389	3,318	4,350
GNI per capita, PPP (current international $)	7,830	6,320	5,790	5,420	5,840	6,640	7,280	7,890	8,120	8,270	8,800	9,210	9,760	**7,475**	12,033	8,163	5,737	9,848	7,695	9,551	8,054
Agriculture, value added (% of GDP)	10.33	10.45	14.93	13.85	11.81	10.67	10.28	9.60	9.81	9.78	9.87	9.71	..	**10.92**	5.04	9.80	11.94	7.84	5.64	4.91	6.62
Industry, value added (% of GDP)	33.81	32.97	33.10	35.84	34.06	34.31	33.23	34.24	33.14	33.41	34.13	34.20	..	**33.87**	44.10	32.16	37.09	34.01	39.17	36.93	33.94
Services, etc., value added (% of GDP)	55.86	56.58	51.97	50.31	54.13	55.03	56.49	56.17	57.04	56.81	55.99	56.10	..	**55.21**	50.86	58.04	50.99	58.15	55.19	58.16	59.44
Exports of goods and services (% of GDP)	..	77.65	59.63	52.39	45.84	38.58	40.19	41.09	39.64	40.90	46.48	48.46	..	**48.26**	56.69	77.52	33.16	41.47	25.21	58.77	31.23
Imports of goods and services (% of GDP)	..	86.13	54.16	53.57	45.92	49.48	49.67	56.82	49.20	49.25	52.29	54.73	..	**54.66**	58.04	83.67	32.79	43.67	26.89	64.08	30.65
Current account balance (% of GDP)	..	..	..	5.73	3.80	-8.46	-5.28	-13.92	-6.79	-7.02	-2.49	-3.71	-6.90	**-4.50**	-3.56	-5.40	..	-3.64	-2.75	-4.54	..
Total debt service (% of exports of goods and services)	..	..	..	5.03	3.19	4.90	6.06	12.75	19.14	19.73	23.26	27.87	..	**13.55**	11.63	4.91	15.79	34.03	11.81	13.50	20.48
External debt (% of GNI)	..	..	..	14.97	14.25	20.39	24.93	34.03	42.70	49.40	58.28	56.52	..	**35.05**	35.59	30.75	38.37	64.93	47.15	39.57	36.20
Gross international reserves in months of imports	..	..	..	1.24	2.35	2.43	2.72	2.53	3.04	3.49	4.09	4.81	..	**2.97**	3.98	2.39	3.80	3.98	4.25	3.32	5.80
Current revenue, excluding grants (% of GDP)	..	33.00	34.21	36.20	41.77	43.13	43.64	42.50	45.65	43.17	41.68	40.20	..	**40.47**	34.26	30.63	26.44	43.16	34.79	36.45	20.10
Expenditure, total (% of GDP)	..	37.65	38.60	37.35	40.20	44.67	44.83	43.91	45.84	48.66	48.04	45.30	..	**43.19**	36.37	30.70	30.92	49.03	37.72	40.04	21.26
Overall budget balance, excluding capital grants (% of GDP)	..	-4.64	-4.02	-0.90	1.62	-0.90	-0.44	-1.28	0.64	-1.98	-5.05	-2.47	..	**-1.77**	-0.61	0.44	..	-3.67	-1.70	-3.10	..
Gross domestic savings (% of GDP)	-20.89	1.99	18.88	14.27	17.30	6.69	12.47	11.79	14.46	15.20	16.90	18.41	..	**10.62**	27.86	22.48	24.29	22.75	19.89	24.62	22.55
Inflation, consumer prices (annual %)	500.00	122.22	625.00	1,500.00	107.33	3.95	4.30	4.17	6.40	3.46	5.27	4.77	1.98	**222.22**	6.63	22.47	..	18.96	65.16	8.35	..
Illiteracy rate, adult total (% of people ages 15 and above)	3.13	2.98	2.82	2.66	2.50	2.33	2.22	2.10	1.97	1.85	1.72	1.64	1.55	**2.27**	..	0.21	3.12	0.77	0.32	..	8.30
Immunization, DPT (% of children under 12 months)	..	..	83.00	85.00	87.00	90.00	91.00	92.00	93.00	93.00	..	94.00	..	**89.78**	97.86	91.50	87.88	99.28	96.55	99.00	87.98
Improved sanitation facilities (% of population with access)	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	99.00	..	100.00	..
Improved water source (% of population with access)	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	90.94	99.00	..	100.00	..
Life expectancy at birth, total (years)	72.17	72.19	71.24	..	..	72.08	72.37	72.50	..	..	73.28	73.54	73.80	**72.57**	73.57	69.45	68.45	70.20	72.25	72.38	72.27
Mortality rate, infant (per 1,000 live births)	10.70	11.10	11.60	9.90	10.20	8.95	8.40	8.20	8.20	7.70	7.50	7.00	..	**9.12**	7.08	12.09	32.46	11.27	13.04	10.24	22.52
School enrollment, preprimary (% gross)	28.64	21.81	23.60	26.59	30.35	31.51	40.69	35.79	..	..	..	..	..	**29.87**	88.88	75.35	54.55	103.48	46.04	76.12	57.72
School enrollment, primary (% gross)	84.73	81.48	85.65	86.97	86.20	86.22	87.13	91.29	..	..	..	..	..	**86.21**	101.72	101.85	98.70	100.49	98.88	101.46	104.22
School enrollment, secondary (% gross)	76.18	70.65	77.04	82.84	78.21	81.85	81.80	82.11	..	..	..	..	..	**78.83**	90.23	100.34	83.93	92.15	93.11	88.02	70.66
Population growth (annual %)	0.21	-0.06	-0.04	-0.02	-3.02	-2.39	-1.76	-1.13	-0.50	0.13	0.02	-0.09	-0.20	**-0.68**	-0.13	-1.16	0.21	-0.16	0.10	0.19	1.35
Population, total (in million)	4.77	4.78	4.78	4.78	4.78	4.64	4.53	4.45	4.40	4.37	4.38	4.38	4.38	**4.57**	10.30	1.44	473.01	10.22	38.53	5.36	306.90
Urban population (% of total)	54.04	54.38	54.73	55.08	55.43	55.78	56.16	56.55	56.94	57.33	57.72	58.14	58.56	**56.22**	74.60	69.98	63.06	63.55	61.74	57.09	73.29

Source: SIMA database as of October 23, 2003.

Annex Table 3: Croatia - Development Assistance and World Bank Lending

Annex Table 3a: Total Receipts Net (ODA+OOF+Private), 1990-2000

Data in US$ million

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
DAC DONORS	-	-	-	3.8	110	149.3	290.4	953.1	703.3	1610	1215.8
EBRD	-	-	-	-	0	18.3	131.2	88.6	86.3	-10.5	55.1
IBRD	**-**	**-**	**-**	**-**	**-28**	**29.4**	**88.9**	**100.4**	**91.5**	**66.6**	**33.5**
UNDP	-	-	-	-	0	0.1	1.2	0.1	1.1	1.2	0.1
TOTAL MULTILATERAL	-	-	-	-	33.8	59.4	225.7	205.1	207.2	75	130.2
TOTAL DONORS	-	-	0	3.8	143.7	208.9	516.2	1160.8	912.4	1684.4	1344.4
IBRD share of multilateral assistance, %	-	-	-	-	-	49.5	39.4	49.0	44.2	88.8	25.7
IBRD share of total assistance, %	-	-	-	-	-	14.1	17.2	8.6	10.0	4.0	2.5

Source: OECD database.

Annex Table 3b: World Bank Lending by Sector, 1990-2003

Data in US$ million

Sector Board / FY	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*IBRD/ IDA Total*
Economic Policy													**202**			**202**
SAL													202			202
Environment														**26**		**26**
REAL PROP REG & CADASTRE														26		26
Energy																
ENERGY EFF															**5**	**5**
Financial Sector							**10**	**95**	**30**							**135**
CAPITAL MARKET DEV.							10									10
EFSAL								95								95
INVESTMENT RECOVERY									30							30
Health, Nutrition and Population						**40**					**29**					**69**
HEALTH						40										40
HEALTH SYSTEM											29					29
Private Sector Development							**5**			**7**						**12**
TECH ASST							5									5
TA INST REG REF PSD										7						7
Public Sector Governance												**5**				**5**
COURT & BANKRUPTCY ADM (LIL)												5				5
Rural Sector							**17**	**42**								**59**
FARMER SUPPORT SERV							17									17
COASTAL FOREST RECON								42								42
Social Protection														**27**		**27**
PENSION SYS INVST														27		27
Transport						**80**		**102**		**101**		**14**				**454**
HIGHWAY SECTOR						80										80
EMG TRANS/MINE CLR								102								102
RAILWAY MOD. & REST.										101						101
TRADE & TRANS FACIL IN SE EUR												14				14
RIJEKA GATEWAY															157	157
Urban Development					**128**				**41**							**169**
EMG RECON					128											128
EAST SLAVONIA REC									41							41
Water Supply and Sanitation									**36**							**36**
MUN ENV INFRA									36							36
Total Lending					**128**	**120**	**32**	**239**	**107**	**108**	**29**	**19**	**202**	**53**	**162**	**1,199**

Source: Business Warehouse, November 19, 2003.

Annex Table 4: Economic and Sector Work

No.	*Document Title*	*Date*	*Report No*	*Document Type*
1.	Croatia - Country Economic Memorandum: A Strategy for Growth through European Integration Vol. 1 of 2 (English)	7/1/2003	25434	Economic Report
2.	Croatia - Country Economic Memorandum: A Strategy for Growth through European Integration Vol. 2 of 2 (English)	7/1/2003	25434	Economic Report
3.	Trade Policies and Institutions in the Countries of South Eastern Europe in the EU Stabilization and Association Process Vol. 1 (English)	3/28/2003	24460	Sector Report
4.	Croatia - Regaining Fiscal Sustainability and Enhancing Effectiveness - A Public Expenditure and Institutional Review Vol. 1 (English)	11/30/2001	22155	Economic Report
5.	Croatia - Economic Vulnerability and Welfare Study Vol. 1 (English)	4/18/2001	22079	Economic Report
6.	Republic Of Croatia - Policy Directions for Transport Vol. 1 (English)	6/15/1999	19447	Sector Report
7.	Republic Of Croatia - Policy Directions for Transport Vol. 2 (English)	6/15/1999	19447	Sector Report
8.	Croatia - Beyond Stabilization Vol. 1 (English)	12/19/1997	17261	Economic Report

Source: Imagebank, as of September 23, 2003.

Annex Table 5: Ratings for Croatia

Annex Table 5a: OED Ratings of Closed Projects, Exit FY90-04

Country	*Total Evaluated ($M)*	*Outcome % Sat ($)*	*Inst Dev Impact % Subst ($)*	*Sustainability % Likely ($)*	*Total Evaluated (No)*	*Outcome % Sat (No)*	*Inst Dev Impact % Subst (No)*	*Sustainability % Likely (No)*
Croatia	**482.0**	**65.0**	**45.0**	**100.0**	**11.0**	**81.8**	**45.5**	**81.8**
Estonia	**109.6**	100.0	74.0	100.0	**7.0**	100.0	85.7	100.0
Hungary	**3,220.0**	96.7	72.0	92.0	**38.0**	89.5	65.8	89.2
Poland	**3,214.4**	87.0	69.0	90.4	**28.0**	78.6	57.1	74.1
Slovak Republic	**130.4**	100.0	100.0	100.0	**3.0**	100.0	100.0	66.7
ECA	**35,206.2**	**72.9**	**47.5**	**73.9**	**450.0**	**79.3**	**49.5**	**72.2**
The World Bank	**253,908.4**	**76.0**	**42.6**	**65.7**	**3,384.0**	**70.5**	**38.3**	**54.9**

Source: Business Warehouse as of March 22, 2004.

Annex Table 5b: Croatia – Projects Evaluated by OED, FY90-03

Proj ID	*Proj Name*	*Sector Board*	*Net Com*	*Len Instr Type*	*Appr FY*	*Exit FY*	*Eval Date*	*Eval Type*	OED Ratings *Outcome*	*Sustain-ability*	*Institutional Dev*
P008327	EFSAL	Financial Sector	82.9	ADJ	97	FY02	2003	PPAR	MODERATELY UNSATISFACTORY	LIKELY	MODEST
P008328	EMG RECON	Urban Development	128.0	INV	94	FY00	06/13/2001	**	MODERATELY SATISFACTORY	LIKELY	MODEST
P008329	HIGHWAY SECTOR	Transport	79.9	INV	95	FY01	10/28/2002	PPAR	UNSATISFACTORY	LIKELY	MODEST
P039002	ISTRIA WATER SUPPLY & SEW	Water Supply and Sanitation	26.0	INV	89	FY00	2003	PPAR	MODERATELY SATISFACTORY	LIKELY	MODEST
P039450	HEALTH	Health, Nutrition and Popul	38.9	INV	95	FY00	08/21/2000	**	SATISFACTORY	HIGHLY LIKELY	SUBSTANTIAL
P040139	INVESTMENT RECOVERY	Financial Sector	20.8	INV	98	FY03	06/30/2003	**	MODERATELY SATISFACTORY	HIGHLY LIKELY	MODEST
P040142	CAPITAL MARKET DEV.	Financial Sector	8.0	INV	96	FY99	2003	PPAR	MODERATELY UNSATISFACTORY	LIKELY	MODEST
P008335	FARMER SUPPORT SERV	Rural Sector	14.3	INV	96	FY03	09/30/2003	**	MODERATELY SATISFACTORY	LIKELY	SUBSTANTIAL
P040830	TECH ASST	Private Sector Development	5.0	INV	96	FY00	2003	PPAR	MODERATELY SATISFACTORY	LIKELY	SUBSTANTIAL
P044457	EMG TRANS/MINE CLR	Transport	78.2	INV	97	FY02	08/09/2002	**	SATISFACTORY	LIKELY	SUBSTANTIAL
TOTAL			**482.0**						**314.2**	**482.0**	**136.4**
Satisfactory/ Sustainable/ Substantial, % of Total									**65%**	**100%**	**28%**

Source: Business Warehouse as of Nov. 18, 2003, PPARs for EFSAL, Emg Recon, Highway Sector, Istria Water Supply, Capital Market Development and Tech Asst.
*IBRD lending for the Isria project was approved for the former SRFY ($60 m). $26.0 m was later transferred to Croatia.
** Internal assessment by OED.
1. Latest Risk Rating: H=High; S=Substantial; M=Modest; N=Low or Negligible; NR=Not Rated.
2. Latest DO, Latest IP Outcome: HS=Highly Satisfactory; S=Satisfactory; U=Unsatisfactory; HU=Highly Unsatisfactory; NA=Not Applicable; NR=Not Rated.
3. Project Status: C=Close; A=Active.
4. Outcome: MS=Moderately Satisfactory; MU=Moderately Unsatisfactory; S=Satisfactory; HS=Highly Satisfactory.

Annex Table 5c: Projects at Risk

Country	*# Proj*	*Net Comm Amt*	*# Proj At Risk*	*% At Risk*	*Comm At Risk*	*% Commit at Risk*
Estonia	1	25.0	0	0.0	0.0	0.0
Croatia	11	447.6	0	0.0	0.0	0.0
Hungary	1	31.6	0	0.0	0.0	0.0
Poland	10	996.7	0	0.0	0.0	0.0
Slovak Republic	5	281.6	0	0.0	0.0	0.0
ECA	277	15,943.0	49	18%	3,082.7	19%
World Bank	**1,354**	**94,444**	**267**	**20%**	**17,722**	**19%**

Data as of: 11/16/2000.
Source: Business Warehouse as of 11/20/2003.

Annex Table 6: Croatia - Bank's Senior Management, 1992-2002

Year	*Vice President*	*Country Director*	*Chief/Resident Representative*
1992	Wilfried Thalwitz	Kemal Dervis	Anil Sood
1993	Wilfried Thalwitz	Kemal Dervis	Michel Noel
1994	Wilfried Thalwitz	Kemal Dervis	Michel Noel
1995	Wilfried Thalwitz	Kemal Dervis	Michel Noel
1996	Johannes F. Linn	Jean-Michel Severino	Michel Noel
1997	Johannes F. Linn	Jean-Michel Severino	Michel Noel
1998	Johannes F. Linn	Anil Sood	Sandor Sipos
1999	Johannes F. Linn	Arntraud Hartmann	Sandor Sipos
2000	Johannes F. Linn	Arntraud Hartmann	Sandor Sipos
2001	Johannes F. Linn	Andrew Vorkink	Vacant
2002	Johannes F. Linn	Andrew Vorkink	Indira Konjhodzic

Source: World Bank Group Directory.

Annex Table 7: Croatia - Millennium Development Goals

Indicators	1990	1995	1999	2000
1. Eradicate exreme poverty and hunger				
Population below $1 a day (%)	..	..	2.0	..
Poverty gap at $1 a day (%)	..	..	0.5	..
Income share held by lowest 20% (1998)	..	..	8.8	..
Malnutrition prevalence, weight for age (% of children under 5)	..	0.6	..	..
Prevalence of undernourishment (% of population)	..	..	15.0	..
2. Achieve universal primary education				
Net intake rate in grade 1 (% of official school-age population)	..	57.7	22.6	..
School enrollment, primary (% net)	78.8	82.3	71.9	..
Persistence to grade 5, total (% of cohort)	..	..	..	..
Literacy rate, youth total (% of people ages 15-24)	99.6	99.7	99.8	99.8
3. Promote gender equality				
Ratio of girls to boys in primary and secondary education (%)	97.3	96.8	97.2	..
Ratio of young literate females to males (% ages 15-24)	99.9	100.0	100.0	100.0
Share of women employed in the nonagricultural sector (%)	44.8	44.9	45.8	..
Proportion of seats held by women in national parliament (%)	..	..	31.0	31.0
4. Reduce child mortality				
Mortality rate, under-5 (per 1,000 live births)	12.5	10.4	9.5	9.3
Mortality rate, infant (per 1,000 live births)	10.7	8.9	7.7	7.5
Immunization, measles (% of children under 12 months)	..	92.0	92.0	..
5. Improve maternal health				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	18.0	..	..
Births attended by health staff (% of total)	..	..	..	..
6. Combat HIV/AIDS, malaria and other diseases				
Prevalence of HIV, female (% ages 15-24)	..	..	0.0	..
Contraceptive prevalence (% of women ages 15-49)	..	..	69.0	69.0
Number of children orphaned by HIV/AIDS	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	..	..	61.0	..
Tuberculosis cases detected under DOTS (%)	..	..	..	..
7. Ensure environmental sustainability				
Forest area (% of land area)	31.5	..	31.9	31.9
Nationally protected areas (% of total land area)	..	6.6	7.5	..
GDP per unit of energy use (PPP $ per kg of oil equivalent)	..	3.9	4.1	..
CO2 emissions (metric tons per capita)	..	3.8	4.5	..
Improved water source (% of population with access)	..	..	95.0	95.0
Improved sanitation facilities (% of population with access)	..	..	100.0	100.0
Secure internet servers	..	..	44.0	44.0
8. Develop a Global Partnership for Development				
Unemployment, youth total (% of total labor force ages 15-24)	..	..	29.8	..
Telephone mainlines (per 1,000 people)	172.1	282.8	364.8	..
Mobile phones (per 1,000 people)	0.1	7.4	65.9	230.9
Personal computers (per 1,000 people)	..	22.0	67.0	80.7
General indicators				
Population, total	4.8 million	4.6 million	4.4 million	4.4 million
GNI (current US$)	18.1 billion	18.8 billion	19.7 billion	18.7 billion
GNI per capita, Atlas method (current US$)	..	3,410.0	4,580.0	4,620.0
Literacy rate, adult total (% of people ages 15 and above)	96.9	97.7	98.1	98.3
Fertility rate, total (births per woman)	1.6	1.6	1.4	1.4
Life expectancy at birth, total (years)	72.2	72.1	73.3	73.3
Aid (% of GNI)	..	0.3	0.2	0.4
External debt (% of GNI)	..	20.4	55.9	64.7
Private fixed investment (% of gross domestic fixed investment)	..	..	77.3	78.4
Trade (% of GDP)	163.8	88.1	89.4	95.6

Source: World Development Indicators Database, September 2003.

Note: In some cases the data are for earlier or later years than those stated.

Annex Table 8: Proposed and Actual Lending
(US$ million)

LENDING

	Pre-1995 country strategy		
	1994	**1995**	**TOTAL**
Proposed			
Actual	**128**	**40**	**168.0**

	mid-1990's country strategy				
	1995	**1996**	**1997**	**1998**	**TOTAL**
Proposed	*200.0*		*100.0-150.0*		*300.0-350.0*
Actual	**80.0**	**31.5**	**239.0**	**106.9**	**457.4**

	1999 CAS			
	1999	**2000**	**2001**	**TOTAL**
Proposed	*108.3*	*257.6*	*224.0*	*589.9*
Actual	**108.3**	**29.0**	**18.9**	**156.2**

	2001 CAS Progress Report		
	2002	**2003**	**TOTAL**
Proposed	*202.0**	*75.0*	*277.0*
Actual	**202.0**	**53.0**	**255.0**
	TOTAL		
Proposed			*1,166.9-1,216.9*
Actual			**1,036.6**

	Post-Progress Report	
	2004	**TOTAL**
Proposed		
Actual	**156.5**	**161.5**

	TOTAL 1994-2004
Proposed	***1,230.9***
Actual	**1,198.1**

*The 1999 CAS proposed lending of US$ 160 million in 2002. However, for 2002, the 1999 CAS was superceded by the CAS Progress Report.
Source: Business Warehouse as of 09/02/2003, mid-1990's country strategy, CAS 1999, CAS Progress Report 2001.

List of People Interviewed

Government Officials

Ingrid Anticevic-Marinovic
Minister, Ministry of Justice

Andro Vlahusic
Minister
Ministry of Health

Cilic Davor
Assistant Minister
Ministry of European Integration

Slavko Linic
Deputy Prime Minister Confirmed
Government of Rep. of Croatia

Miroslav Bozic
Assistant Minister
Ministry of Agriculture and Forestry

Roland Zuvanic
Minister
Ministry of Maritime Affairs,
Transport and Communications

Krunoslav Placko
Assistant Minister
Ministry of Economy

Venko Curlin
Deputy Minister
Ministry of Public Works,
Reconstruction and Construction

Josip Kulisic
Assistant Minister
Ministry of Finance

Ana Hrastovic, Ministry of Finance
Advisor, World Bank
Executive Director's Office

Zeljko Grzunov
Assistant Minister
Ministry of Public Works,
Reconstruction and Construction

Goran Granic
Deputy Prime Minister
Govt. of Rep. of Croatia

Davorko Vidovic
Minister
Ministry of Labour and Social Welfare

Vera Babic
Assistant Minister
Ministry of Labour and Social Welfare

Ruzica Terze
Assistant Minister
Ministry of Labour and Social Welfare

Nino Zganec
Assistant Minister
Ministry of Labour and Social Welfare

Mr. Sc. Vanja Bilic
Pomocnik Ministrice

Igor Raguzin
Senior Counsellor
Ministry of Economy

Boris Maksijan
Counselor, Ministry of Economy

Olja Zaninovic
Deputy Head
Foreign Economic Relations Department
Ministry of Economy

Darko Polanec
Ministry of Economy

Vlatka Kucevic
Ministry of Economy

Mr. Sc. Vladimira Ivandic
Ministarstvo Financija

Bank/Fund Staff

Harry Broadman – Manager of SAL, ECA

Peter Parker – Highway Sector, ECA

Elana Kasterova – Transport Specialist, ECA

Michel Audige – Lead Transport Specialist, ECA

Hans Flickenschield – Mission Leader, IMF

Tetsuya Konuki – Economist, IMF

John Norregaard – Resident Representative, IMF

Andrew Vorkink – Former Country Director

Myla Taylor Williams – Country Program Coordinator

Albert Martinez – PAL Task Manager, EFSAL Task Manager

Gerardo Corrochano
EFSAL Task Manager

Olivier Godron – EFSAL Task Manager, Country Economist

Michel Noel – Former Division Chief

Akiko Maeda – Task Team Leader, Health

Rena Eichler – New Task Team Leader, Health

Bernard Funck – Sector Manager, ECA

Sandor Sipos – Former Resident Representative in Country, ECA

Lubomira Beardsley – Legal Department

Csaba Csaki – Agriculture Department

Catherine Kleynhoff – Former Country Officer

Kyle Peters – Former Sector Manager

Anil Markandya – Environment

Arntraud Hartmann – former Country Director

Manuel Marion – Lead Water and Sanitation Specialist, ECA

Ilene Photos – TA Project Manager, ECA

Yves Duvivier – ECA (Privatization and Public Enterprise Reform)

Julius Varallyay – Former Lead Country Officer

Tetsuya Konuki
IMF (HQ)

Indira Konjhodzic
Country Manager

Sanja Madzarevic-Sujster
Country Economist, The World Bank
Croatia Country Office

Bruce Courtney
Country Economist, The World Bank
Croatia Country Office

Other Institutions

Vesna Zivkovic
Depository Agency

Katarina Ott
Head
Institute for Public Finance

Jack Connolly
Country Rep., CRS

Ms. Marija Kolaric
Member of the Board
Croatian Bank for Reconstruction and Development

Vedrana Carevic
Director of Foreign Credit Transaction Dept., Croatian Bank for Reconstruction and Development

Jacques Wunenburger
Del. of the EC to Croatia

Predrag Bejakovic
Instut za javne financije

Mirna Pavletic-Zupic
Assistance Director
Agency for Protection of Market Competition

Mario Markovic
Head of Dept.
Agency for Protection of Market Competition

Branimira Kovacevic
Sr. Adviser
Agency for Protection of Market Competition

Maladen Cerovasc
Adviser
Agency for Protection of Market Competition

Maja Landsman
Director
Intl. Fin. Inst. Dept.
Croatian National Bank

Martina Dalic
Chief Economist
Privredna Banka

Jadranka Primora
Executive Dir. of Fin. Institution

William Jeffers
Director
USAID

Zoran Bohacek
President
Croatian Association of Banks

Vitomir Begovic
Head of Office
Office for Social Partnership Govt. of Croatia

Ivica Smiljan
Head of Office
Deloitte & Touche

Lidija Pavic-Rogosic
Director
ORDAZ

Vlado Puljiz
Center for Social Studies
Law Faculty

Zeljko Lovrincevic
Institute of Economics

Tomislav Reskovac
President
Open Society Institute of Croatia

Ivan Kolar, President
Croatian Farmers' Association

Dunja Vidosevic
President
First Housing Savings Association

Bozena Mesec
Secretary to the Fund
Croatian Privatization Fund

Josip Kregar
Professor
Law Faculty

Ante Babic
Vice President
Economia Moderna

Vedran Sosic
Member
Economia Moderna

Zeljko Ivancevic
General Director
Croatian Employers' Association

Sima Krasic
Auditor General
State Audit Agency

Lidija Pernar
Assistant Auditor General
State Audit Agency

Ivo Sulenta
Deputy Director
CROSEC

Andrija Stampar
School of Public Health
Stipe Oreskovic Head

Andrew Krapotkin
EBRD

Davor Bajuk, L.L.B.
Legal Advisor
Central Depository Agency Inc.

Laura Garagnani
Counsellor
European Union
Biserka Birus

Ljiljana Marjanovic
Relationship Manager
Bank of Zagreb

Zlatan Janes
Head of Department
Agency for Protection of
Market Competition

Zeljka Skrbina
Senior officer
International Financial
Institutions Department
Croatian National Bank

William A. Jeffers
Mission Director
USAID, American Embassy Zagreb

Srecko Macekovic
Deputy of the Management
Board

Clay W. Epperson
Program Officer
USAID
American Embassy Zagreb

Richard Howard
Deloitte & Touche d.o.o.

Lidija Horvatic
Director
Croatian Employers' Association

CROATIA COUNTRY ASSISTANCE EVALUATION

Management Action Record of OED Recommendations and Management Response

Major Monitorable OED Recommendations Requiring a Response	*Management Response*
• The Bank should lend to assist Croatia's infrastructure development only where government support for reforms is adequate and faulty past policies are replaced by more appropriate policies.	• Management fully agrees that any future Bank support for infrastructure investment should be linked to sound sectoral reform. In the past this was attempted through policy dialogue, with varied impact. The proposed Programmatic Adjustment Loan (PAL) program – will likely have a pillar for fiscal consolidation which will possibly include Railway reforms – should be a more effective instrument for ensuring this linkage.
• The Bank should assist reforms in health, education, and pensions to achieve fiscal balance and improved sector performance.	• Management fully agrees that the Bank should support reforms in health, education, and pensions – not only because public expenditure is high but also because the effectiveness of such spending needs to improve. Management proposes to reinforce its ongoing investment support for pension and health reforms by addressing associated financing sustainability issues through the PAL program, and to support reforms in the education and health sectors through investment lending aimed at strengthening sector management and service delivery.
• Future assistance should focus on improving the core functions of government, public administration reform, and judicial sector reform with lending contingent on adequate government ownership of reforms.	• Management fully agrees that Bank support for public administration and judicial sector reforms should be a high priority in the Bank's assistance program for Croatia, and recognizes that such reforms cannot be implemented unless there is sufficient government ownership of them. To that end, the proposed PAL program would support reforms of public administration, public expenditure management, and the judiciary, noting that these reforms typically take long to bear fruit.
• The Bank should assist government to devise programs and policies to accelerate the transformation of enterprises privatized under faulty past programs, including the reprivatization of enterprises reverting to government ownership, while ensuring that this reprivatization cannot be repeated in the future.	• Management agrees that the Bank should support acceleration of transformation of enterprises privatized under faulty past programs. The proposed PAL program would include support for disposal of non-performing state-owned assets, as well completion of enterprise privatization, including *agro-kombinats*.

Guide of OED's Country Assistance Evaluation Methodology

1. This methodological note describes the key elements of OED's country assistance evaluation (CAE) methodology.[42]

CAEs rate the outcomes of Bank assistance programs, not Clients' overall development progress

2. An assistance program needs to be assessed on how well it met its particular objectives, which are typically a sub-set of the Client's development objectives. If an assistance program is large in relation to the Client's total development effort, the program outcome will be similar to the Client's overall development progress. However, most Bank assistance programs provide only a fraction of the total resources devoted to a Client's development by donors, stakeholders, and the government itself. In CAEs, OED rates only the outcome of the Bank's program, not the Client's overall development outcome, although the latter is clearly relevant for judging the program's outcome.

3. The experience gained in CAEs confirms that program outcomes sometimes diverge significantly from the Client's overall development progress. CAEs have identified assistance programs which had:

- satisfactory outcomes matched by good Client development;
- unsatisfactory outcomes in Clients which achieved good overall development results, notwithstanding the weak Bank program; and,
- satisfactory outcomes in Clients which did not achieve satisfactory overall results during the period of program implementation.

Assessments of assistance program outcome and Bank performance are not the same

4. By the same token, an unsatisfactory assistance program outcome does not always mean that Bank performance was also unsatisfactory, and *vice-versa*. This becomes clearer once we consider that the Bank's contribution to the outcome of its assistance program is only part of the story. The assistance program's outcome is determined by the *joint* impact of four agents: (a) the Client; (b) the Bank; (c) partners and other stakeholders; and (d) exogenous forces (e.g., events of nature, international economic shocks, etc.). Under the right circumstances, a negative contribution from any one agent might overwhelm the positive contributions from the other three, and lead to an unsatisfactory outcome.

5. OED measures Bank performance primarily on the basis of contributory actions the Bank directly controlled. Judgments regarding Bank performance typically consider

[42] In this note, *assistance program* refers to products and services generated in support of the economic development of a Client country over a specified period of time, and *client* refers to the country that receives the benefits of that program.

the relevance and implementation of the strategy, the design and supervision of the Bank's lending interventions, the scope, quality and follow-up of diagnostic work and other AAA activities, the consistency of Bank's lending with its non-lending work and with its safeguard policies, and the Bank's partnership activities.

Evaluation in Three Dimensions

6. As a check upon the inherent subjectivity of ratings, OED examines a number of elements that contribute to assistance program outcomes. The consistency of ratings is further tested by examining the country assistance program across three dimensions:

(a) a *Products and Services Dimension,* involving a "bottom-up" analysis of major program inputs -- loans, AAA, and aid coordination;

(b) a *Development Impact Dimension,* involving a "top-down" analysis of the principal program objectives for relevance, efficacy, outcome, sustainability, and institutional impact; and,

(c) an *Attribution Dimension,* in which the evaluator assigns responsibility for the program outcome to the four categories of actors (see paragraph 4. above).

Rating Assistance Program Outcome

7. In rating the outcome (expected development impact) of an assistance program, OED gauges the extent to which major strategic objectives were relevant and achieved, without any shortcomings. Programs typically express their goals in terms of higher-order objectives, such as poverty reduction. The country assistance strategy (CAS) may also establish intermediate goals, such as improved targeting of social services or promotion of integrated rural development, and specify how they are expected to contribute toward achieving the higher-order objective. OED's task is then to validate whether the intermediate objectives produced satisfactory net benefits, and whether the results chain specified in the CAS was valid. Where causal linkages were not fully specified in the CAS, it is the evaluator's task to reconstruct this causal chain from the available evidence, and assess relevance, efficacy, and outcome with reference to the intermediate and higher-order objectives.

8. Evaluators also assess the degree of Client ownership of international development priorities, such as the Millennium Development Goals, and Bank corporate advocacy priorities, such as safeguards. Ideally, any differences on dealing with these issues would be identified and resolved by the CAS, enabling the evaluator to focus on whether the trade-offs adopted were appropriate. However, in other instances, the strategy may be found to have glossed over certain conflicts, or avoided addressing key Client development constraints. In either case, the consequences could include a diminution of program relevance, a loss of Client ownership, and/or unwelcome side-effects, such as safeguard violations, all of which must be taken into account in judging program outcome.

Ratings Scale

9. OED utilizes six rating categories for **outcome**, ranging from highly satisfactory to highly unsatisfactory:

Highly Satisfactory:	The assistance program achieved at least acceptable progress toward all major relevant objectives, and had best practice development impact on one or more of them. No major shortcomings were identified.
Satisfactory:	The assistance program achieved acceptable progress toward all major relevant objectives. No best practice achievements or major shortcomings were identified.
Moderately Satisfactory:	The assistance program achieved acceptable progress toward *most* of its major relevant objectives. No major shortcomings were identified.
Moderately Unsatisfactory:	The assistance program did *not* make acceptable progress toward *most* of its major relevant objectives, *or* made acceptable progress on all of them, but either (a) did not take into adequate account a key development constraint or (b) produced a major shortcoming, such as a safeguard violation.
Unsatisfactory:	The assistance program did not make acceptable progress toward *most* of its major relevant objectives, *and* either (a) did not take into adequate account a key development constraint or (b) produced a major shortcoming, such as a safeguard violation.
Highly Unsatisfactory:	The assistance program did not make acceptable progress toward *any* of its major relevant objectives and did not take into adequate account a key development constraint, while also producing at least one major shortcoming, such as a safeguard violation.

10. The **institutional development impact (IDI)** can be rated as: *high*, *substantial*, *modest*, or *negligible*. IDI measures the extent to which the program bolstered the Client's ability to make more efficient, equitable and sustainable use of its human, financial, and natural resources. Examples of areas included in judging the institutional development impact of the program are:

- the soundness of economic management;
- the structure of the public sector, and, in particular, the civil service;
- the institutional soundness of the financial sector;
- the soundness of legal, regulatory, and judicial systems;
- the extent of monitoring and evaluation systems;
- the effectiveness of aid coordination;
- the degree of financial accountability;
- the extent of building NGO capacity; and,
- the level of social and environmental capital.

11. **Sustainability** can be rated as *highly likely*, *likely*, *unlikely*, *highly unlikely*, or, if available information is insufficient, *non-evaluable*. Sustainability measures the resilience to risk of the development benefits of the country assistance program over time, taking into account eight factors:

- technical resilience;
- financial resilience (including policies on cost recovery);
- economic resilience;
- social support (including conditions subject to safeguard policies);
- environmental resilience;
- ownership by governments and other key stakeholders;
- institutional support (including a supportive legal/regulatory framework, and organizational and management effectiveness); and,
- resilience to exogenous effects, such as international economic shocks or changes in the political and security environments.

Government Comments on the Draft CAE

REPUBLIC OF CROATIA
MINISTRY OF FINANCE

Zagreb, 25 March 2004

The World Bank
Operations Evaluation Department
Attn: Mr. Ajay Chhibber, Director
Fax: 00 1 202 477 6391

Re: Croatia – Country Assistance Evaluation

Dear Sirs:

We refer to your leter dated February 19, 2004 including the draft of the Croatia Country Assistance Evaluation, where you ask us to provide you with our views on the Bank assistance to Croatia during 1991-2003.

First of all, we would emphasise our good and highly cooperative relationship with the World Bank during the concerned period of time, esspecially in the sense that the World Bank has provided financial sources and contributed greately to the social and economic recovery of Croatia after the war.

Concerning the document in question, we agree with the overall tone of it, however, we have noticed that the data used are mostly out-of-date. Please note that:

a) the data on percentage of the population schooling mentioned in Section 1.9, page 3, matches data from 1981,
b) the collateral registry mentioned in Section 3.9 has been established in February 2004 and is to become fully operative by the end of this year,
c) data mentioned in Section 3.10 are taken from EBRD's Transition Report for 2001 while Transition Report for 2003 is available.

The evaluation shows us the mismatch in approved and proposed lending, as well as delays occuring in many of the porposed lending. We believe these points should be taken into consideration by new CAS presently being formulated, in order to avoid same mistakes. Therefore we welcome new CAS document which should set out the key reforms needed for Croatia's membership in the EU and we strongly welcome Bank's assistance and support in that matter.

Yours sincerely,

ASSISTANT MINISTER OF FINANCE

Josip Kulišić

Cc:

- Mr. Ad Melkert, Executive Director
- Mr. Anand K. Seth, Country Director
- Mrs. Indira Konjhodžić, Country Manager
- Mrs. Sanja Madžarević Sujster, Economist

Croatia: Proposed and Actual Lending

Country Strategy Proposal/New			*$ (millions)*	*Actual*	*$ (millions)*	*Purpose*
FY94	Emergency Recon	pre-CAS	128	FY94	128	
FY95	Health	pre-CAS	40	FY95	40	
Mid-1990's country strategy						
FY96-98	Highway Sector		_1/	FY95	80	c
FY96-98	Farmer Support		_1/	FY96	17	b
FY96-98	Cap. Markets		_1/	FY96	9.5	b
FY96-98	Technical Assistance	New	_1/	FY96	5	a,b
FY96-98	EFSAL		_1/	FY97	95	b
FY96-98	Coastal For.	New	_1/	FY97	42	Recon.
FY96-98	Emrg. Mine-Clearing	New	_1/	FY97	102	Recon.,c
FY96-98	Invst.Recov		_1/	FY98	30	b
FY96-98	Mun Inf. Env (Rij/Spl)		_1/	FY98	36.3	c
FY96-98	East Slavonia	New	_1/	FY98	40.6	Recon.,c
FY96-98	PSAL		_1/	dropped		a
FY96-98	ASAL		_1/	dropped		b
FY96-98	Employ/training		_1/	dropped		d
FY96-98	Energy Privatization		_1/	dropped		b,c
FY96-98	Forestry		_1/	dropped		e
FY96-98	Zagreb Heating		_1/	dropped		c
FY96-98	Health II		_1/	FY00, (see FY99 CAS)		a
FY99 CAS						
FY99	Railways	CAS	101	FY99	101	2
FY99	T.A.II	CAS	7.3	FY99	7.3	all
FY00	Health II	CAS	25	FY00	29	2,5
FY 00	SAL	CAS	200	FY02	202	all
FY00	Trade	CAS	9.3	FY01	13.9	4
FY00	Courts/Bankruptcy	CAS	5	FY01	5	3,4
FY00	Kastela Bay Cultural	CAS	18.3	dropped		4
FY01	Energy Restruct.	CAS	50	dropped		2
FY01	Judicial/Regulatory Ref.	CAS	30	dropped		3
FY01	Social Protection	CAS	30	dropped		5
FY01	Pension Sys.Inv.	CAS	20	FY03	27.3	5
FY02	National Environment	CAS	40	dropped		4
FY02	Road Maintenance	CAS	31	dropped		2
FY02	Rijeka Port	CAS	40	FY04	156.5	4
FY02 CAS PR						
FY 03	Cadastre	CAS	25.7	FY03	25.7	3
N.A.	Energy Eff.	CAS PR	N.A.	FY04	5.0	2

_1/ The mid-1990's country strategy did not specify amounts or fiscal year for proposed projects.

Purpose Code as defined in each CAS, with reconstruction added to original program,

Mid-1990's country strategy: (a) Reforming public finance; (b) Encouraging private sector growth, (c) Rebuilding and upgrading infrastructure, (d) Poverty, (e) Environment

FY99 CAS: (1) Short-term macro and financial stability, (2) Sustainable growth: reducing size of public sector and increasing efficiency; (3) Sustainable growth: improving governance, (4) Sustainable growth: promoting competition, infra, improving environment, culture, (5) Sustainable growth: poverty alleviation

FY02 CAS PR: as for FY99 CAS, with poverty alleviation redefined as social protection

The Bank initiated lending to Croatia prior to a CAS with the Emergency Reconstruction Project (ERP) (FY94, US$128 million), and a Health project (FY95, US$40 million). The mid-1990's country strategy proposed fourteen projects for FY96-98, for US$350 million, but only 6 were approved during the country strategy period. Four new projects were added, including three relevant reconstruction projects which addressed the impact of fighting with Serbia.[43] Only one of the seven projects (Health II) which slipped from the country strategy period was subsequently implemented, and six were dropped, including two adjustment operations, signaling delayed transformation.[44]

Twelve projects were proposed in the FY99 CAS base case for FY99-02, while two ongoing projects approved in FY99 (Railways and T.A.) that had not been in the FY95 CAS were noted. Only one of the twelve projects was implemented during the CAS period, while two were implemented subsequently.

The CAS Progress Report was issued in FY02 as the democratically elected government sought Bank assistance for reform and enhanced relations with Western Europe. In sharp contrast to the slippage noted above, all of the five projects which the CAS PR proposed FY02-03, including the SAL, are now being implemented. Cooperation on ESW also improved, and the Public Expenditure Review and the Poverty Report were also implemented.

---

[43] East Slavonia Reconstruction project and Emergency Transportation and Mine Clearing Project.

[44] An Agriculture Sector Loan and the Public Sector Adjustment Loan, the latter after a considerable amount of resources had been expended. This experience with adjustment lending was consistent with IMF relations with Croatia, which saw its Extended Arrangement (approved March 12, 1997, for SDR 353 million) lapse unused after the initial purchase.

Overview of IFC Operations*

(Member of IFC since 1993)

1. IFC Activities

Investment Portfolio: IFC investments in Croatia have been in the form of equity and loans in the financial markets and in general manufacturing projects. As of end October 2003, IFC committed portfolio in Croatia stood at US$97.5 million comprising:

- Equity and a loan investment in a paper mill plant, aimed at rebuilding and modernizing the facility;
- Quasi equity investment in a leading pharmaceutical complex;
- Equity and a loan investment to modernize a ship repairing facility in Rijeka;
- Loan investment in Croatia Banka as a pre-privatization facility;
- Loan investment to a regional bank for a credit line to support housing finance and SME on-lending; and
- Equity investment in a venture capital fund.

Also, over the years, IFC has helped its clients mobilized about US$98 million in syndicated loans.

2. IFC Results

IFC has been successful in supporting several commercially productive enterprises in Croatia with strong foreign exchange earnings and employment opportunities, as well as in developing the financial sector. IFC has also been helping strategically important Croatian companies to grow into regional industry leaders. Some of the IFC's successful projects are:

- ***Bjelovarska Banka,*** a small regional bank, which was later merged into Erste & Steiermarkische Bank. IFC financing helped the bank become one of the few intermediaries actively providing term finance to SMEs and to companies operating in less developed regions outside Zagreb.

- ***Belisce:*** Croatia's leading producer of packaging paper and corrugated boxes. IFC helped the company to enhance its international competitiveness and increase exports, comply with international environmental standards, and acquire 100 percent of the shares in a cardboard and packaging material company in neighboring Slovenia, creating one of the largest cardboard and packaging materials makers in south-eastern Europe. This was the first cross-border acquisition in the paper/packaging industry in Southern Europe.

- ***Pliva***: This is the largest pharmaceutical company in Central and Eastern Europe. IFC has supported the growth and strategic development of the company's research and development infrastructure. This project has a broad positive impact on Croatian

* Provided by IFC's Europe & Central Asia Department.

society through providing employment opportunities to local scientists in their home country, and thus helping to curb of the high level of "brain drain".

- **Croatia Capital Partnership LP (CCP),** a 10-year private-equity fund. IFC's investment in CCP increased the Fund's profile, helped it reach a critical size, and improved its portfolio companies' access to financing.

3. Economic Problems/Opportunities in the Country that Have Affected Portfolio Performance

Since 1999, the investment climate has improved. The 2000 election has improved political stability. The government that took office has pursued structural reforms, fiscal sustainability, and has encouraged foreign direct investment. The government has also been successful in privatizing some key sectors of the economy, notably the financial services industry and telecommunications. There is an increased optimism about Croatia's growth prospects as the EU accession process is gaining momentum and the country has strong external liquidity. As a result, IFC has increased its activities in Croatia during 2000-2003, committing funds in 6 projects for a total of about US$96 million.

4. Obstacles to Greater Private Activity and Foreign Direct Investment

To date the majority of Foreign Direct Investment (FDI) flows to Croatia have been related to the privatization program. There has been limited greenfield FDI. Obstacles to further increases in FDI include: (i) difficulties and complexities in business licensing and registration; (ii) ineffective land register and cadastre; (iii) long delays in granting visas and work permits; (iv) a fiscal, regulatory and legal policy framework not in line with best international practice; (v) slow privatization process of public utilities, infrastructure and the tourism sector; (vi) lack of a clear and transparent legislative environment; and (vii) slow restructuring in sensitive sectors such as agriculture and shipbuilding.

5. IFC's Strategy

Croatia's economy is at a relatively advanced stage so that IFC's interventions can be more sophisticated and oriented towards catalyzing market-based solutions to private and public sector issues.

Financial Sector

The banking sector has undergone restructuring and consolidation. Several major foreign banks have entered the market, most of them with greenfield operations. The privatization process is well advanced with major banks sold to foreign banks. As a result the market is more competitive, profitability is improved, and deposits have grown indicating increased confidence in the market. Therefore, in the banking sector IFC will focus on structured finance and housing mortgage transactions. Development in the non-banking sector has been much slower. Consequently, IFC strategy is to increase its

activities primarily with non-bank financial institutions with a focus on mortgage finance and development of the local bond market.

Real Sector

IFC's strategy is to support privatization and post-privatization restructuring in key sectors of the country such as tourism, shipbuilding, food processing, and construction material. IFC will support dynamic companies in Croatia that seek to extend operations across borders. Support for improving corporate governance is another area where IFC will continue to have an important role to play in Croatia.

SME Sector

The growth of SMEs in Croatia has been restricted by limited availability of long-term funds and the perception of high-risk held by the banking industry. Therefore, IFC will continue to follow a dual approach: strengthening the financial sector and providing credit lines for on-lending to SMEs. IFC has invested in a private equity fund with a focus on the SME sector. In addition to providing loans for on-lending to SMEs, IFC has been offering technical assistance to client banks to better enable lending operations to SMEs.

Foreign Direct Investment (FDI)

FIAS completed two studies in 2000, one on incentives reform, another on administrative barriers to FDI. After a long process of consultation with the government and the private sector, a comprehensive draft report on administrative barriers to investment was presented to the government in 2001. Since then, FIAS has provided assistance to the government in developing a structured methodology and applying a number of tools for identifying administrative barriers and removing them in order to improve the overall investment climate in the country.[45] Its recommendations provided a very valuable guide to the Government in modernizing administrative procedures to investors in Croatia. The analysis of the report has encouraged the government to accelerate its reform and focus not only on legislation, but also on how regulations are applied in practice. Since 2001, the government has established a high-level coordinating group to address administrative barriers and bottlenecks identified in the FIAS study. However, 70 percent of this program has not yet been implemented.

Infrastructure

IFC will continue to search for suitable investment opportunities in the infrastructure sector, focusing on those transactions where IFC has a well-defined role to play.

---

[45] Source: FIAS, Selected Administrative Procedures for Doing Business in Croatia, 21 August 2003.

Cross Border Integration

The private sector may play an important role in economic development and cross-border integration in the region. IFC strategy is to support dynamic companies in Croatia that seek to extend across borders. Implementing this strategy, IFC has invested in a paper manufacturing facility and in a leading pharmaceutical company, both looking for opportunities to expand their operation in the neighboring countries. IFC will also support regional infrastructure projects.

Client Surveys: Methodology

The Client Survey for 1998 was conducted on a stratified sample of 198 key clients of the World Bank in Croatia. The list was compiled by the World Bank and given to a local market research agency. The key client list of the Client Survey consists of people in Croatia who are directly involved in the planning, management or evaluation of the World Bank's program and those who have had sufficient experience with the World Bank's activities and adequate information about its work. The client list comprised people who work for government, for NGOs, the media, academic and research organizations, and the business community. Respondents were guaranteed anonymity. They were first informed of the survey by the World Bank, then given the survey by the local market research agency, which followed up with telephone calls to ensure a high response rate. Of the 198 respondents who were contacted and sent questionnaires, 133 returned the completed survey, a response rate of 67 percent, of which 41 percent were government officials, 32 percent were entrepreneurs, 10 percent were NGO staff, 9 percent R&D staff, and 8 percent were journalists.

The Client Survey for 2003 was based on three focus group discussions in two cities, Zagreb and Osijek, although a background survey of 1010 Croatians was also used to gain information on perceptions. The focus groups comprised journalists, members of NGOs, economists, business managers, politicians and government officials.

Chairman's Summary
Committee on Development Effectiveness

Croatia Country Assistance Evaluation
Meeting of April 21, 2004

1. The Informal Subcommittee (SC) of the Committee on Development Effectiveness (CODE) met on April 21, 2004 to discuss the Croatia Country Assistance Evaluation prepared by the Operations Evaluation Department (OED).

2. **OED Evaluation Findings**. The evaluation finds that Bank loans to Croatia to support reconstruction had successful outcomes, but operations to reform public finance had mixed success. Although some reforms (pensions and health) started in the 1990s, they were not wide-ranging, and public expenditures continued to grow with little retargeting. Since 2000, reforms in pensions and health deepened, and were initiated in other areas supported by Bank ESW and lending. Public expenditures, while still high, have since decreased as a percentage of GDP. Operations to raise growth have also had a mixed impact. The fiscal 1997 EFSAL privatization program was flawed, while financial sector reforms were successful. The fiscal 2002 SAL reforms have had a positive impact on the labor market, and new bankruptcy and company laws should help improve enterprise performance over time. The impact of operations to strengthen public administration has been limited. The SAL that has just closed helped improve some aspects of budget management. At the present juncture, the Bank should assist Croatia to (1) rationalize and retarget public expenditure to support reforms in health, education and infrastructure, and to contain debt; (2) foster private sector-led growth first by improving the environment for founding new enterprises and second, by ensuring that privatization of SOEs or reprivatization of failed enterprises that are reverting to government ownership is successful, in particular by not favoring insider buyouts; and (3) improve the core functions of government, public administration, and the judicial sector.

3. **Comments from Management**. Management agreed with the major findings and recommendations of the evaluation. It noted, however, that the report could have better highlighted the fact that while the Bank may not have had the full buy-in of the government on governance and other issues, its involvement had been vitally important at an early stage to gain knowledge and to establish a presence in the country that had helped it to accelerate the transformation and reform process once conditions permitted.

4. **Main Conclusions and Next Steps**. Members welcomed the OED evaluation, which they said was of high quality, and broadly endorsed its findings and recommendations. They noted with satisfaction that Croatia would soon start negotiations for its eventual EU membership. Speakers noted the progress in the outcome of the Bank's assistance to the country after FY01, and commended both the Bank and Croatia for this. Some of them looked forward to a more robust lending and AAA program in the upcoming country strategy to help the country carry forward the reform agenda. A speaker said greater Bank focus was needed with respect to judicial, civil service and privatization reforms. Another speaker underscored the need for further investment in human capital. He added that governance should be strengthened. Members noted that Croatia was a middle-income, post-conflict transition economy that was also in the midst of EU accession negotiations, and said the Bank would have to be extraordinarily innovative in responding to its unique challenges. The main issues raised by the Subcommittee are detailed below.

5. The Chair representing Croatia agreed with the findings and recommendations of the evaluation, including that the reform agenda had to be owned by the government. She commended the highly cooperative relationship between Croatia and the Bank since 1991, and noted that the office in Zagreb facilitated close cooperation with the Government on major reforms. She urged that the mismatch between approved and proposed lending noted in the evaluation, as well as delays in some of the proposed lending, be taken into consideration in the new country strategy in order to avoid the same mistakes. The speaker briefed the Subcommittee on the broad spectrum of reforms underpinned by the recent SAL, and said an important development was that even after completion of the SAL and the change in government at the end of 2003, there had not been a reversal of reform. The authorities were convinced that their efforts to preserve macroeconomic stability and complete the necessary structural reforms were critical for sustainable growth. With respect to Croatia's application for EU membership, she said that the European Commission had recently recommended that the European Council start membership negotiations with Croatia.

6. **Donor Coordination**. Subcommittee members underscored the importance of working closely with other donors, particularly during preparation of the next country strategy. They highlighted in particular the roles of the EBRD and the EU, and said Croatia's upcoming EU accession was an opportunity to coordinate work with other partners and identify appropriate priorities to maximize the impact of each aid partner. Some speakers said a more substantive analysis of IFC's and MIGA's role during the past decade would have been useful. Others asked for further information on how the Bank's cooperation with donors, including the EBRD, could be further strengthened. Management responded that, as in the case of the recent cohort of new member countries to the EU, there would be a major focus on coordination through the European Commission with the European institutions, including the EBRD and EIB.

7. **Infrastructure.** Several Subcommittee members underscored the importance of infrastructure development for the sustainable development of the country. They noted the important lesson that large infrastructure projects were not necessarily beneficial in the absence of policy reform. A speaker asked how constraints in the key infrastructure areas were being addressed through policy dialogue and technical assistance so that infrastructure investment could be successfully scaled up. Another speaker noted the increase in the budget deficit caused by the financing of highway sector projects aimed at building the capacity of the economy to generate future savings. He asked about the appropriate balance between building the capacity of the economy and creating higher deficits, keeping in mind the risks of macroeconomic instability. Management said that Croatia had a huge public sector in terms of public expenditure to GDP. Any progress made on infrastructure had to be closely related to the reprioritization of public expenditure.

8. **The Importance of Ownership**. The Subcommittee noted that the report underscored the limitations of Bank involvement in the absence of Government ownership of lending programs. Speakers generally agreed that Government ownership was important for Bank operations in all countries. A speaker said that to regain political and social support for the reform process in Croatia, it was important to define and implement a strategy where people could clearly understand what gains to expect from the reforms and why the reforms were constructed as they were. Another speaker asked about the role ESW had played in building government ownership. Some speakers noted that about two-thirds of the approx. $1.2 billion of IBRD lending to Croatia over a decade was committed under conditions that were not appropriate. One of them said this kind of commitment had real costs in terms of fairness across the Bank's `membership and in terms of the efficacy of assistance to Croatia itself. Moreover, Croatia now had to bear the repayment burden. The speakers asked why the Bank had adopted this passive attitude, and whether there were different decisions that management could have

taken or critical decision points that the Board was not alerted to. Another speaker noted that aid was more effective in environments of good policy and effective institutions. He asked how effective the Bank had been in disseminating good practices for improving the effectiveness of aid, and what actions were envisaged to enhance the dialogue and consensus-building for the implementation of successful public sector reforms.

9. Staff noted that almost all Bank financed activities in Croatia had focused on post war reconstruction and rehabilitation, and these had been judged by OED to have been largely successful. Through AAA and sustained policy dialogue, the Bank had helped successive governments to focus on structural reforms, bringing in the lessons of relevant experience. The level and focus of Bank assistance beyond rehabilitation and reconstruction, including adjustment lending, had also been suitably adjusted based on the Government's commitments to reform. The $1.2 billion figure, staff added, referred to total commitments. Outstanding debt to the Bank was about half that amount, representing less than five percent of total Croatian debt and roughly two percent of Croatian debt service.

10. **Privatization and Other Reforms.** Speakers noted with surprise that while the overall privatization process in Croatia had failed, financial sector reforms had been successful. They asked for the reasons behind the relative success of privatization in the banking sector, and what lessons could be learned from this experience. A speaker asked whether issues of timing, speed and sequencing were behind the overall failure of the privatization process. It was important, he noted, for an appropriate legal and regulatory framework to be in place before actual privatization took place. Another speaker underscored the importance of strengthening the private sector, and suggested that the Bank help the authorities to identify what sectors could be developed. A speaker said that the implementation of an effective strategy directed at reforming public spending and at identifying priorities for increased public spending, as well as improvement of the privatization process related to state-owned enterprises, were the fundamental issues the Government and the Bank should deal with if substantial progress was to be made in the medium term.

11. OED responded that reform ownership in the banking sector had resulted from duress. The sector had been in an extremely difficult position and the country had no choice but to privatize. Staff added that privatization of banking had generally been more successful because it had nearly always been associated with the participation of strategic foreign partners as the primary instrument. However, public enterprise restructuring had been generally pursued by Croatia with a blend of tested and untested instruments. Going forward, lessons learnt would be applied to ensure transparent and competitive processes which lead to efficient outcomes with minimal risks of return to state ownership.

Chander Mohan Vasudev
Chairman